FUNDAMENTALS
of
BANKING THEORY AND PRACTICE

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PUBLISHERS' NOTE for the FOURTH EDITION

THE book has again been thoroughly revised to make it conform to the latest Three-year Degree Course syllabus. The author has spared no pains to increase the usefulness of the book by incorporating in it all latest information and developments. The book, we hope, will be eminently suitable for Three-year Degree (Commerce) course students of the Universities of India as also for those who will be going in for the examination of the Indian Institute of Bankers and other such examinations.

We regret, however, that this revised edition could not be brought out earlier.

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PREFACE TO THE FIRST EDITION

THE writing of the book was undertaken in undivided India but had to be completed in divided India. The major part of the book was written up before the partition of the country, and certain conclusions reached at that time had to be reviewed and revised in the light of the subsequent developments arising from the division of the country. The partition has brought in its train sweeping changes in the political, social and economic outlook of the people and the basic structure of the country. The painful impact thereof is too well known to all to need any repetition, although those poignant memories still linger. As a student of banking, I have taken account of those changes as well and tried to make a realistic study of their repercussions in the sphere of banking as far as practicable. But I owe an apology to the readers if they find some links missing in certain conclusions arrived at before but later on revised, for reasons already stated.

Being connected with banking, I felt some years back an urge to write a book on that subject, but it did not fructify until I became associated with the City College, Commerce Department, as a Professor of Economics and Banking. Ideas, which were more or less in a nebulous form, had to be expressed in definite terms to the students and the book is the ultimate product thereof. This book aims at a mere exposition of the banking principles, laws and practice in India and abroad within a short compass, and is primarily intended for students going in for the degree course and the examination of the Indian Institute of Bankers and other such examinations. To suit the convenience of the students, the book has been divided into three parts, the first part dealing with the principles of banking and central banking in different countries, the second part with the Indian money market and banking and the third part with practical banking. I have spared no pains to make the book as much useful to students as possible so that they may have, as beginners, sufficient materials for a proper understanding of banking principles and practical banking

operations. My efforts in this respect will be amply rewarded if it proves useful to those for whom it is intended.

I must acknowledge my gratitude to Mr. A. K. Sen, M.A., M.Sc. (Econ.), Bar-at-Law, Vice-Principal, City College, Commerce Department, for many helpful suggestions to enhance the utility of the book and to Prof. L. R. Das Gupta, City College, Commerce Department, who helped me in more than one way.

I am indebted to Mr. K. N. Dalal, Managing Director, Nath Bank Ltd., Calcutta, for encouragement received from him in pursuit of my studies on the subject. I am also grateful to Mr. M. G. Nath, Manager, Mr. J. K. Nag, Accountant, Mr. N. K. Sinha, Foreign Exchange Department and Mr. R. N. Ghosh, Research and Statistics Department of the Nath Bank Ltd., Calcutta, for many useful suggestions on practical banking. I must also thank Mr. K. D. Roy, B.Com., R.A. of Lovelock & Lewes, Calcutta, for providing me with materials for account-keeping, and auditing of banks. I acknowledge my gratitude to Mr. S. Ghose, Managing Director, Calcutta Press Ltd., but for whose help the book would not have seen the light.

November, 1948. A. K. BASU

PREFACE TO THE THIRD EDITION

THE book has this time been thoroughly revised and enlarged. The recommendations of the Shroff Committee and of the All-India Rural Credit Survey, which is a monumental document, have been summarised and the expanded activities of the Reserve Bank of India in different spheres described in detail. The role of the State Bank of India in the planned set-up has also been fully narrated. Part III of the book dealing with practical banking has been enlarged so that it may prove useful even to practical bankers. In short, I have spared no pains to increase the usefulness of the book by incorporating in it the recent information and development. After the book had gone to press, there were, however, several amendments to the Banking Companies Act, 1949, particularly of sections 10, 12, 16, 27, 35, 36, etc. The Bank rate has also been further raised to 4% ushering in an era of dear money policy.

I am grateful to Shri A. R. Mukherjee, Managing Director, A. Mukherjee & Co. Private Ltd., Calcutta for bringing out the revised edition within the shortest possible time. As the revision work had to be completed quickly, it is likely that some mistakes may remain undetected in the book.

Calcutta,
27th June, 1957

A. K. BASU

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PART I

CHAPTER I

FUNCTIONS AND SERVICES OF A BANK

JUST as a tree is known by its fruits, so is a bank by the functions it discharges. Money is what it does. Similarly banking may be defined by what it performs. A description of the functions and services of a bank indicates the general nature of a bank and the place it occupies in a country's economy. A general definition of a bank or banking is by no means easy, as the concepts of banking differ from age to age, and country to country. Further, it is not possible to make an exhaustive catalogue of its functions and services, as they are diverse, varied, ever expanding, and have wide ramifications. With the progress of civilisation banking is assuming wider functions, and greater responsibilities. It cannot be said with certainty what should be the last ditch for banking, as it is on the march. As the functions of banking are widening, it will not be wrong to say that banks will assume, in course of time, a complete control of the economic life of man. Without attempting to catalogue exhaustively banking functions let us, however, discuss some of the fundamental functions usually discharged by a bank.

It is held that a bank borrows money with one hand and lends with the other. In an analysis of this dual rôle of banking lies its true nature. A bank becomes a borrower in the sense that it receives deposits repayable either on demand or after the expiry of a specified period from the public, who then become its creditors. Deposits on "Current Accounts" are withdrawable on demand either in cash or by cheques. Deposits which are made for three months, six months, one year, three years or more and are withdrawable after those specified periods, are called "Fixed Deposits" or "Time Liabilities". Fixed Deposits may also be made for shorter periods than three months, which are technically called "Short Deposits". Deposits are also received in savings bank accounts subject to certain restrictions on the amount so receivable and withdrawable. Usually in India

deposits exceeding Rs. 10,000/- are not received in savings bank accounts except by a special arrangement with the bank and the sum so deposited is not withdrawable more than once a week. A sum exceeding Rs. 1,000/- ordinarily requires one week's notice in advance before it can be withdrawn from the savings bank account. Thus a bank discharges the important function of pooling the scattered savings of the people and serves, so to say, as the reservoir of public savings.

Next, a bank is to perform another important function—that of applying those accumulated public deposits to productive uses by way of loans, advances, overdrafts and cash-credits against approved securities. The soundness of the bank depends upon the safety and liquidity of such advances and a bank is to exercise much caution and judgment in the selection of investments and securities. Approved securities include, among other things, gold or silver bullion, Government securities, easily saleable stocks and shares and marketable goods. The banks facilitate trade and commerce by discounting bills of exchange covering marketable commodities as well. As advances are the main sources of income of a bank, it has got to devote much attention to their proper selection.

A bank is to render important services by providing an inexpensive medium of exchange like notes or cheques. Formerly private banks had the authority to issue notes as convenient media of exchange but later on that authority was taken away by the Central Bank of a country, which usurped to itself the exclusive right of issuing notes. In India, the Reserve Bank of India has been invested with the monopolistic right of note-issue and all banks, other than the Reserve Bank of India, have been prohibited from issuing any promissory note payable to bearer. But with the currency of cheques the bank has created a very convenient medium of exchange.

In addition to these, the bank performs a variety of other functions like agency services, general utility services and miscellaneous services. A catalogue of agency services is given below:

(1) *Collection and payment of promissory notes, cheques, bills, coupons, dividends, subscriptions, rents or other periodical receipts and payments like insurance*

premia: These are to be done as an agent of the constituents for which charges are levied by the bank.

(II) *Purchase and Sale of Securities*: As bankers are well aware of the market conditions, the clients usually instruct their respective banks to sell or purchase securities on their behalf by debiting their accounts at the best market rate. For such services the bank sometimes makes little or no charge.

(III) *Remittances of funds on behalf of clients by drafts or mail-transfers or by telegraphic transfers.*

(IV) *Acting as executors, trustees and attorneys*: In this respect banks are better fitted to do this job than other agencies. *Firstly*, banks in normal circumstances and specially those of undisputed soundness and credit, promise continuous existence which cannot be guaranteed by other persons or bodies. *Secondly*, they can be relied on for their integrity and the work may with safety be entrusted to them. *Thirdly*, banks employ experts on the staff, specialised in such technical work, who, by dint of their experience and business judgment, can capably manage the administration of such trust properties. Besides these, banks employ income-tax experts to prepare the income-tax returns of their clients and to help them to obtain refund of income-tax in appropriate cases.

(V) *Serving as correspondents, agents or representatives of their customers, other banks or financial corporations*: As already pointed out in (IV) banks on behalf of their customers carry on correspondence with income-tax authorities. They obtain passports, travellers' tickets, secure passages for their customers, receive on their behalf letters and redirect them to those for whom they are intended.

Besides the agency services, a modern bank is to perform some general utility or miscellaneous services, of which the following are important. In such cases the banks do not act as agents of the customers.

(I) *Issuing of letters of credit, circular notes, bank-drafts, travellers' cheques, etc.*

(II) *Dealing in foreign exchange.*

(III) *Underwriting loans to be raised by the Government, public bodies and corporations*: In India the participation of joint-stock banks in such underwriting-business is not so considerable as in Germany where the banks are participating increasingly in such business.

(IV) *Serving as referee to the financial standing, business reputation and respectability of customers*: Such a function is in the course of development in India. Such information is essential for gauging the credit-worthiness or otherwise of any business man and so should be collected with great care and passed on with the utmost secrecy.

(V) *Compiling statistics and business information regarding possibilities of trade, commerce and industry*: Some banks publish their monthly bulletins containing valuable statistics and data about financial matters, which are of immense help to the mercantile community.

(VI) *Receiving in safe custody of valuables and securities.*

In India the Banking Companies Act, 1949 enumerates specifically certain functions which are permissible for a banking company to discharge and a bank is prohibited from engaging in any form of business other than those mentioned in Section 6(1) of the said Act.

A 'banking company' in India has been defined as one which transacts the business of banking which means the accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise. In addition to the business of banking a banking company may engage in any one or more of the following forms of business, namely:—

(*a*) the borrowing, raising or taking up of money ; the lending or advancing of money either upon or without security ; the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hoondees, promissory notes, coupons, drafts, bills of lading, railway receipts, warrants, debentures, certificates, scrips and other instruments, and securities whether trans-

ferable or negotiable or not ; the granting and issuing of letters of credit, travellers' cheques and circular notes ; the buying, selling and dealing in bullion and specie ; the buying and selling of foreign exchange including foreign bank notes ; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock, bonds, obligations, securities and investments of all kinds ; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or others ; the negotiating of loans and advances ; the receiving of all kinds of bonds, scrips or valuables on deposit, or for safe custody or otherwise ; the collecting and transmitting of money and securities ;

(*b*) acting as agents for any Government or local authority or any other person or persons ; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and otherwise acting as an attorney on behalf of customers, but excluding the business of a managing agent of a company.

(*c*) contracting for public and private loans and negotiating and issuing the same ;

(*d*) the effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, of State, Municipal or other loans or of shares, stock, debentures, or debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue ;

(*e*) carrying on and transacting every kind of guarantee and indemnity business ;

(*f*) managing, selling and realising any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims ;

(*g*) acquiring and holding and generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advance or which may be connected with any such security ;

(*h*) undertaking and executing trusts ;

(*i*) undertaking the administration of estates as executor, trustee or otherwise ;

(*j*) establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences calculated to benefit employees or ex-employees of the company or the dependants or connections of such persons ; granting pensions and allowances and making payments towards insurance ; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general, or useful object ;

(*k*) the acquisition, construction, maintenance and alteration of any building or works necessary or convenient for the purposes of the company ;

(*l*) selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company ;

(*m*) acquiring and undertaking the whole or any part of the business of any person or company, or when such business is of a nature enumerated or described in this sub-section ;

(*n*) doing all such other things as are incidental or conducive to the promotion or advancement of the business of the company ;

(*o*) any other form of business which the Central Government may by notification in the Official Gazette specify as a form of business in which it is lawful for a banking company to engage.

Classification of Banks

It is difficult to classify banks, since banking functions, organisations and their nature differ from country to country. A proper classification of banks is further complicated by this fact that a bank, specialised in a particular branch of functions, may assume, within limits of safety, a few more functions, which are beyond its legitimate sphere and should have fallen within the ...tion of some other banks specialised in that line. In this

context a classification, if attempted at all, of banks is not likely to conform strictly to realities. Still such a classification will help us to understand the nature of functions, which a bank is best suited for performing, together with the organisation of banking, and also to comprehend fully the implications of specialisation in the sphere of banking just as in other spheres of economic activities. So it will be advisable to classify banks with reference to the functions they are specialised in discharging, and accordingly our classification will be what is called a functional classification of banks. Banking in general may be classified as (*a*) commercial banking, (*b*) industrial banking, (*c*) agricultural banking, (*d*) savings banking, and (*e*) central banking.

Commercial banks usually receive deposits for a short period and are, therefore, to lay out funds in such a manner that they can get back those funds with some return, within that short period. Generally, commercial banks, by their very nature, cannot lend for a long term without undermining their liquid position. Commercial banks are chiefly concerned with the supply of short-term credit requirements of trade and commerce.

Industrial banks, as the name signifies, are to meet the long-term credit needs of industries. These banks are to provide credit in order to enable the industrial undertakings to raise their block and working capital. Industries require capital for two purposes: (*a*) Capital for block, *i.e.*, finance for fixed and permanent assets like machines, tools, appliances, structures, land etc. Capital invested in these fixed assets is of the nature of "permanent investment". Leaving aside the requirements for block capital of the industries to be started, even the established industries require block capital for extensions and replacements. (*b*) Working capital of an industry is needed for "the purchase and working up of raw materials into financing outstandings in respect of goods supplied and for providing the necessary funds for meeting day-to-day requirements". Working capital is necessary for financing floating assets. The relative proportion between block and working capital varies according to the nature of industries and their size. As a rule block capital consumes the bulk of industrial finance. In India, it is estimated that 60% to 70% of the total capital requirements of an average cement-factory are earmarked for the purchase of block capital like machinery and plant. In a paper-mill in India

more than 50% of the finance is required for fixed assets. In a jute mill the requirement for block capital is double that of the working capital requirement. Out of a total capital requirement of a match factory for Rs. 30 lacs, about Rs. 23 lacs were estimated by the Tariff Board of India to be required for block and Rs. 7 lacs for meeting working capital. For starting a tea-garden of the minimum size, the initial capital requirement is estimated to be Rs. 7½ lacs. As there is a long interval between the opening up of the tea-garden and the yield of tea, there is the necessity for a steady flow of fixed capital for purchasing plant, machinery, acquiring land and constructing buildings. And the garden is to be worked up for a minimum period of 5 to 6 years before there is actual production. On the whole, such is the position with regard to most of the industrial enterprises. As it is not safe for commercial banks to lock up funds for a long time by financing the industrial concerns, some alternative institutions like industrial banks should have to be evolved to supply long-term finance to industries.

In almost all the leading countries of the world there are separate industrial banks to provide industrial finance. Japan founded her industrial bank called the Industrial Bank of Japan as early as 1902, Finland her Industrial Mortgage Bank in 1924 with a share capital of 50 million Finnish marks. So also was the National Hungarian Industrial Mortgage Institute established to grant amortisation loans to the industries of Hungary. For the same purpose, the National Economic Bank of Poland was formed to supply long-term credit to industries.

Germany furnishes a classic example of the utility of industrial banks in promoting the industrialisation of that country. There those banks make current account advances to the industrial concerns to provide working capital as well as block capital for extensions in anticipation of recourse to the investment market. Besides these, those banks come forward to provide the initial capital of the newly started industries sometimes by underwriting their entire shares. With a view to minimising risks it is common for those banks to join together in what is called a *Konsortium* and pledge themselves to accept a certain portion of the issue. Thus the industrial banks actively participate in the promotion of new industrial companies. In Germany even the joint-stock banks are very much interested in providing industrial finance, which they

often do, by appointing one of their men as a Director on the Board of the industrial company, which they like to finance. These banks grant short-term as well as long-term credits but the short-term credits are generally utilised for short-term purposes. Long-term credits for new or old established industrial undertakings are usually raised by issuing shares and debentures and selling them to the investing public. "It should never be forgotten," says Dr. Goldschmidt, "that Germany owes the great industrial development of the 'sixties, the 'nineties and the first decade of this century in a large measure to what one may describe as the entrepreneur spirit in banking."

In England, where joint-stock banks always fight shy of industrial finance, an organisation named the Credit for Industry Limited was floated in 1934, with the Bank of England holding its shares as well as controlling interest therein with a view to providing block and working capital for small and medium-sized industries by way of loans varying from 2 years to 20 years. In addition to this, two such institutions, namely, the Finance Corporation for Industry (F.C.I.) and the Industrial and Commercial Finance Corporation (I.C.F.C.) were started to provide capital for big industries. The purpose of the F.C.I. is the provision of temporary or longer period finance for industrial business of that country with a view to their quick rehabilitation and development in the national interest, thereby assisting in the maintenance and increase of employment. Like most true institutions it is feeling its way cautiously by adjusting itself to changed conditions. During the first year it could do little or no business with basic industries, which are expected to be its principal customers. In fact, the business undertaken by the Corporation has largely been with medium-sized undertakings which required finance to embark on new processes. As usual with British institutions the second one, *i.e.*, I.C.F.C. worked conservatively on commercial principles and assessed carefully the profitability of enterprises that it undertook to finance. It followed the principle not of carrying "lame ducks" but of helping "ducks that can swim". The I.C.F.C. caters mainly for the financial needs of small and medium-sized industrial and commercial businesses whose requirements fall within the limits of £5,000 and £20,000. Its object is to supplement and not to replace existing finance.

The financial facilities extended by it take any of such forms as debentures and secured loans, redeemable preference shares, non-redeemable preference shares, participating preference shares and ordinary shares.

The Industrial Development Bank of Canada was constituted under the Industrial Development Act in 1944 for the purpose of extending financial assistance to sound industrial concerns which were unable to obtain finance from other sources on reasonable terms. The enterprises eligible under the Act for assistance are those which are engaged in the manufacturing, processing or refrigeration of any goods, the building of ships, the generating or distributing of electricity. Financial assistance is normally given on a medium or long-term basis. This bank is virtually owned by the Bank of Canada.

In Australia the Royal Commission on Australian Monetary and Banking Systems recommended that with the assistance of the Commonwealth Bank, the Government should explore the possibility of establishing a suitable machinery to meet the financial needs of small industrial concerns. Accordingly, the Industrial Finance Department was created within the Commonwealth Bank of Australia. The accounts and transactions of this Department have been kept separate from those of the other Departments of the Commonwealth Bank. The following are the functions of the said Industrial Finance Department:

(1) To provide finance for the establishment and development of industrial undertakings, particularly small undertakings.

(2) To assist in the establishment and development of industrial undertakings.

(3) To tender advice on the operations of industrial undertakings with a view to promoting the efficient conduct thereof.

The Australian experiment is an interesting innovation in the domain of industrial banking.

In India the need for industrial banks cannot be over-emphasized. In our country, the Industrial Finance Corporation of India was started in 1948 with a capital of Rs. 5 crores subscribed by the Government, the Reserve Bank of India, and banks and insurance companies for the purpose of making medium

and long-term credits more readily available to industrial concerns in India when normal banking accommodation is inappropriate or recourse to capital issue methods impracticable. Several State Finance Corporations have also been promoted in the different States of India to provide capital to medium-sized and small industries.

The various functions which are to be discharged by industrial banks have been described brilliantly by the Macmillan Committee as follows: Acting as financial advisers to existing industrial concerns, advising in particular as to the provision of permanent capital, its amounts and types, securing the underwriting of and issuing of the Company's securities to the public and, if necessary, assisting previously in arranging for the provision of temporary finance in anticipation of an issue, assisting in financing long-term contract at home or new developments of an existing company, or founding companies for entirely new enterprises, acting as intermediaries and financial advisers in the case of mergers or in the case of negotiations with corresponding groups, and generally be free to carry out all types of financing business. But it should be remembered that these banks cannot solve industrial problems, which must be solved by the industry itself.

Agricultural Banking

The credit needs of agriculturists are of three kinds: short-term, intermediate, and long-term. Short-term credit is required for the purchase of manure, seeds, expenses of transportation, weeding, hoeing, reaping, thrashing, payment of land revenue or rent and for meeting current outgoings, and the marketing of produce. The agriculturists have to raise the yield from the land, for which better agricultural implements and cattle may have to be purchased. For this purpose intermediate credit is needed. Long-term credit is required for effecting permanent improvements of the land, digging of channels to drain out water, consolidation of holdings, redemption of low land, repayment of ancestral debts, acquisition of costly equipment. Short-term credit is of a seasonal character, intermediate credit varies from one year to three years and long-term credit from three years or more. In view of certain peculiarities of agricultural finance it is not possible for commercial banks to provide this finance on a large scale. *Firstly*, in agriculture, the

unit of production being essentially a one-man concern, credit is to be limited to personal worth. *Secondly,* the operations of a farmer being complex and subject to exceptional risks from weather changes and diseases, agricultural finance is to contend with these risks. *Thirdly,* in agriculture the need for finance remains constant, although production may be unprofitable. *Fourthly,* agriculture having little control over supply, it is exposed to price-fluctuations. *Fifthly,* land is the only security for long-term credit and it is the most unsuitable security from the standpoint of commercial banks, apart from the difficulties involved in title, and restrictions on the transfer of land. *Lastly,* in India farming being done by the scattered, unorganised and volatile body of small peasants, ordinary credit-machinery is unsuited to serve their needs, when credit is to be granted in small driblets to numerous borrowers.

It is on account of the above reasons that agricultural finance requires a special treatment or a specialised organisation. In no part of the world have the problems of successfully constructing and working the machinery of rural finance and of linking up the agricultural industry and the money market been found to be easy. In India the problem is more difficult. But almost all the countries have evolved separate institutions, namely, agricultural credit, co-operative, and land-mortgage banks, to provide finance to the agriculturists. In Germany the *Landschaften,* both old and new, which raise funds by issuing debentures have, under the supervision of the Government, played a unique rôle by extending long-term loans to agriculturists, repayable by amortisation payments within 53 years. In France the same job is done by the *Credit Fonchier* of France, which acts as the apex bank for the mortgage banks of that country. Loans, short-term and long-term, are granted there on the mortgage of land. Similarly, in the U.S.A. the Federal Land Banks have been established for that purpose. The Agricultural Mortgage Corporation in England is another example of mortgage banking on the security of agricultural land.

In western countries, especially in England, the joint-stock banks provide a large portion of agricultural finance through well-developed branch banking in the interior of the country. The Committee on Agricultural Credit in England (1923) report that out of the outstanding farmers' loans of £46½ million, the "Big

Five" loaned out £20 million for the purchase of agricultural land and £20 million for current trading. In Russia the commercial banks participate to a great extent in supplying short-term agricultural credit. In the U.S.A. also state and national banks combine together to lend for the seasonal operations of agriculture. But one thing is clear from these instances that mortgage banking has been kept distinct from deposit banking and run on separate lines and principles.

Central Banking

At the top of the banking institutions operating in a country stands its Central Bank which is to look after the condition and regulation, where necessary, of the banking operations, the maintenance of the financial stability of the country and the stabilisation of its monetary value, both internal and external. As Kisch and Elkin observe: "The Central Bank of a country stands in a special relationship to the Government, seeing that by its discount policy and the subsequent reactions on credit, gold-reserves and note-issues, it controls the amount of purchasing power available, and is thus responsible for safeguarding the currency standard established by the law." Central banking is distinct from other types of banking, as it is concerned more with the promotion of the general monetary stability of a country than with the earning of profits for its shareholders. It does not compete with other banks for profit but acts as the bankers' bank, and becomes the lender of last resort. Its functions will be discussed later on.

Savings Banking

Savings banking is a device for pooling the scattered savings of the community into a common reservoir. Under such type of banking, deposits received are not withdrawable on demand beyond a certain limit. Any withdrawal beyond the prescribed limit requires a prior notice. The idea is to impose restrictions on the dissipation of such savings on the part of smaller depositors by too frequent withdrawals. It is the experience with most of the small depositors that once they begin to draw upon their savings, they can hardly command any surplus income to replenish those savings

and the tendency of withdrawals continues unchecked. In order to arrest such a tendency and to conserve the savings, restrictions are imposed on the procedure of withdrawals by the savings banks under Government control. Besides postal savings banks, other types of savings banks do exist as well. In Canada, Dominion Government Savings Banks, Provincial Government Savings Offices and Quebec Savings Banks are operating. In America Mutual Savings Banks, quasi-mutual institutions of non-profit-making character function widely.

But now-a-days there is little distinction between savings banks and commercial banks, as the latter are becoming increasingly interested in attracting savings deposits. In commercial banks also, savings deposits are hedged in with various restrictions as to their withdrawals.

The first real Savings Bank was founded in Hamburg in 1765. It is difficult to define Savings Banks but the nature of their functions can be understood with reference to the following:

1. They may be classified according to the nature of their management as mutual, stock and co-operative banks. The first are managed by a self-perpetuating body of trustees who do not share the earnings, the second are managed by the Directors elected by the stock-holders, and the third are managed by officials elected by the members.
2. Postal and Municipal banks are public institutions; mutual, stock and co-operative banks may fall in the category of private institutions.
3. The Savings Bank in the unit system has a separate existence but has no connection with any other bank, as in the U.S.A. There is another type of such banks which is but a part of the chain as in the postal system like the municipal banks of Germany and the co-operative credit banks of Europe.

Mutual or Trustees Savings Banks.—The depositors themselves are the owners of the above type of banks. They have no stockholders and as such the working capital of a mutual bank is derived from deposits from the public. It is agreed that the running expenses of such a bank cannot be met out of the deposits and the way these expenses are met is by subscribing to an "Organisation Fund" created by the Trustees. Besides this, the Trustees

are to build up a "Guarantee Fund" as well to protect the interests of the depositors, by contributions amongst themselves and additions from earnings. The contributions of the Trustees may be repayable in due course out of the profits of the banks. This repayment is, however, not compulsory but is merely a moral obligation. The net profits of those banks are divided amongst the depositors in the form of interest. As these institutions lack profit-motive, they serve little commercial utility. The original Savings Banks, such as the Bank of Savings and the Bowery Savings Bank of New York, were of this type.

The investments of these institutions are to be selected with a close eye to their safety. Mortgage loans form the principal assets of these banks. They generally require 60 to 90 days' previous notice for withdrawal of deposits.

Under the general Law of 1875 the incorporation of such banks has been placed under the control of the Superintendent of Banks in New York State. There the trustees are to invest the funds in stocks issued or guaranteed by the U.S.A., stocks in any State that has not defaulted in payment of principal or interest for a period of ten years preceding the date of investment, and bonds of any Municipality in New York State. In England the deposits of these banks are lent to the National Debt Commissioners who allow interest on all such sums. These banks are primarily intended for pooling the savings of the poorer sections of the people and so restrictions are placed on the maximum amount of deposits receivable so that the richer people may not take advantage of the increased rate of interest offered by such banks in comparison with other classes of banks.

Stock Savings Banks.—These banks raise capital by issuing shares and pay dividends to both stock-holders and depositors unlike the Mutual Savings Banks which pay only to the depositors The depositors are paid a stipulated rate of interest and the profits beyond this are distributed amongst the stock-holders as dividend. Unlike the Mutual Savings Banks, such Stock Savings Banks cannot "scale down" deposits to make up any loss.

Guarantee Savings Banks.—These are a cross between the mutual and stock banks. They receive 'special deposits' in addition to ordinary deposits. A stipulated rate of interest is paid to the general depositors and any surplus beyond this is distributed as

dividend amongst special depositors. These special deposits constitute a guarantee fund for the general depositors.

Municipal Savings Banks.—Municipal Savings Banks are an outgrowth of the municipal activities designed to promote human welfare. These are highly developed in Germany.

People's banks perform the functions of co-operative banks which reconcile the three cardinal rules of maximum of responsibility, minimum of risks, and maximum of publicity.

Postal Savings Banks.—The Postal Savings Bank is not a bank in the true sense of the term. It is more or less a Department of the Government. In Great Britain the deposits, at whatever office made, can be withdrawn from any other office which transacts savings bank business. In India, Post Office Savings Bank deposits have gradually increased from Rs. 106 crores in 1953-54 to Rs. 130 crores in 1954-55 and to Rs. 163 crores in 1955-56. To popularise such deposits, the Bombay General Post Office has introduced with effect from the 16th July, 1956 the system of withdrawal by cheque from Post Office Savings accounts. This facility, which is being afforded for the first time since the establishment of the Post Office Savings Bank Account in 1882, will be restricted for the time being to the ordinary and personal account of literate single and joint depositors at the Bombay G. P. O. Cheque books will be issued to depositors who possess a balance of Rs. 500 and whose accounts have been in existence for not less than six months. These cheques, which may be drawn by a depositor in favour of himself or other persons, can be presented for payment at the Post Office counter or through a bank.

CHAPTER II

SOME FUNDAMENTAL PRINCIPLES OF COMMERCIAL BANKING

IT will be worth our while to discuss some fundamental principles of commercial banking as enunciated by Gilbert in his 'History and Principles of Banking'. A commercial bank should not provide block capital to its customers, which partakes of the nature of long-term advances. It should not accept securities like colliery, mills etc., which are not so quickly realisable. The prudent banker, when asked to grant a loan, will always inquire, in the first place, for what period the advance is required, what is the prospect of repayment at the expiration of the period. If he is not satisfied as to this, he must not let himself be tempted either by the value of the security or the rate of interest offered ; his chief thought must be for the liquidity of advances. Further, a bank must not concentrate advances in a few hands only, but, instead, diffuse its advances amongst many customers so that the possibility of risk is minimised thereby. A banker should, as far as possible, avoid proposals for advances against landed properties, which involve many complications relating to title to properties, notification for the sale of properties and take much time for disposal. Or, in other words, mortgage loans against real estate should be discouraged. A good banker is he who knows the distinction between a bill and a mortgage. The former is a self-liquidating document in the sense that the money may be realised by disposing of the goods covered by the bill, if the drawee fails to retire the bill on maturity, whereas the latter is full of many complications as stated before.

Successful banking depends largely on the management of reserves. Reserves must be sufficient without being excessive. If insufficient, the bank is inviting trouble. Again if the reserves are excessive, that means idle money yielding no income to the bank. The bank manager must, therefore, strike a balance between cupidity and timidity so far as the regulation of reserves is con-

cerned. There is no rigidity of principles about the maintenance of the bank's reserves. But the traditional banking ratios, as determined by century-old experiences in banking, throw light upon the fundamentals governing the bank-reserves. These ratios indicate the manner in which the assets of the bank should be distributed into their component parts as against its total liabilities so as to attain an acceptable standard of liquidity, evolved through years of experience in the sphere of banking. A successful banker is he who can make a useful application of those principles according as circumstances demand.

A banker is to make the maximum use of his funds after due care is taken to safeguard the liquid position of the bank. Accordingly, he will have to make up at the close of business each day a complete statement, which collates all the various positions and gives a clear and concise summary of the financial position of the bank at the commencement of the business the next day, as he is to receive and lend money under various items. The successful day-to-day employment of funds is largely dependent on the long-term view being taken of the business conditions. There are slack periods when there is a plethora of funds in the bank's vaults, incapable of being profitably utilised. It should be the manager's policy to arrange in advance for as much money as possible to be going out during such slack periods. Conversely, at periods when money is in great demand, the banker should see that money is coming in, whether by maturity of investments, time-loans, bills etc. Similarly, in foreign exchange transactions a banker is so to lay out his funds that he may take advantage of the fluctuations in the monetary conditions prevailing in different foreign centres. If money-rates at a foreign centre are lower than the local money-rates, it will be advantageous for a banker, from the point of view of interest, to draw on that centre and create an overdraft there.

When there is an investible surplus with a banker, for which there is no trade demand, it will be advisable for him to have recourse to Government securities comprising short-dated issues.

Much depends upon the capacity of a banker to quote suitable business terms and conditions, which add to the earnings of a bank. A banker is to exercise proper judgment and tact in handling the business propositions of constituents. He should try to be as helpful to his constituents as possible, consistent with the

safety of the bank's interest. Bank-charges should always be subject to a close scrutiny by a bank manager. To enable him to exercise proper control, the various classes of expenditure should, when possible, be sub-divided into sections, such as salaries, rent, stationery, newspapers etc. It should be his concern to reduce expenses, chargeable to the bank's account, as far as practicable, feasible and expedient. By maximising the earnings, minimising the expenses of a bank and liquefying its position, a banker is to give proof of his ability, judgment and imagination.

BANK STATEMENT

A balance sheet of a bank portrays its position during a particular period, usually six months or one year, with specific reference to its liabilities and the distribution of its assets. There is no standardized balance sheet, as its form differs from country to country according to law, practice and custom prevailing there. Still some idea might be formed about the fundamental items of a balance sheet as given below:

LIABILITIES	ASSETS
Capital:	Cash Balance
Authorised	Balances with other banks
Subscribed	Money at call and short notice
Paid-up	Bills discounted
Reserve Fund	Investments
Current deposit and other accounts	Advances to customers
Acceptances, endorsements on account of customers.	Liabilities of customers for acceptances, endorsements etc.
	Bank premises.

The liabilities of a bank represent the sources of its funds which are employed by a bank in the ordinary course of business.

Capital.—The authorised capital is the maximum amount that a bank can issue under its Memorandum of Association. That limit cannot be exceeded without the amendment of the Memorandum of Association in a shareholders' general meeting. It may be that the Directors may not choose to issue capital up to the maximum amount of authorised capital for various reasons. In that case if the authorised capital is Rs. 1 crore, the Directors may choose to issue capital to that extent or less than that, say, Rs. 80 lacs. That

is called 'Issued Capital'. When the capital is issued, the public may subscribe to the capital in full or may subscribe less. If the people subscribe up to Rs. 50 lacs, that will be called the 'Subscribed Capital', *i.e.*, which the people are ready to take up. It is known to all that the entire subscribed capital may not have to be paid at once but in instalments. The amount which is then paid in cash is called the 'Paid-up Capital'. It represents the actual cash-value of the capital contributed by the public. Suppose that the subscribers have paid Rs. 25 lacs out of the subscribed capital of Rs. 50 lacs and the balance of Rs. 25 lacs is payable when further calls will be made. Rs. 25 lacs will then represent the paid-up capital and the balance of Rs. 25 lacs the 'Reserve Liability' of the shareholders, to be paid when further calls will be made. The 'Reserve Liability' is called by the bank in times of necessity or emergency. This liability is kept in reserve against any contingency or eventuality that might befall the bank in future. It represents an additional source of strength for a bank in times of distress. In India the authorised capital, subscribed capital and paid-up capital are to bear a fixed ratio to each other. Thus under Section 12(*i*) of the Banking Companies Act, no banking company incorporated on or after the 15th January, 1937 shall carry on business in India unless it satisfies the condition that the subscribed capital of the company is not less than one-half of the authorised capital, and the paid-up capital is not less than one-half of the subscribed capital and that, if the capital is increased, it complies with the condition prescribed in this clause within such period not exceeding two years as the Reserve Bank may allow. And if any publication is to be made of the authorised capital, the subscribed capital as well as the paid-up capital should have to be publicised in an equally prominent place and types under Section 148 of the Companies Act, 1956. The idea is to prevent some unscrupulous persons from taking advantage of a situation, arising out of the publication of authorised capital only, which may reach astronomical figures, but which is not properly understood by the public who might then be misled by such big figures signifying nothing.

Reserve Fund.—The Reserve Fund is the accumulation of the undistributed profits of the bank, which are kept earmarked for meeting any emergency. This fund is built out of the profits from year to year. If, for some unforeseen reasons, the bank is to incur

some losses, they are made up by drawings upon the Reserve Fund. Naturally this fund should be invested in easily realisable securities, upon which the bank may draw in times of necessity. The need for building up a Strong Reserve Fund cannot be over-emphasized. It is for this reason that Section 17 of the Banking Companies Act makes it a statutory duty on the part of a bank to set apart 20% of the net profits for the Reserve Fund before declaration of any dividend until the amount of the said fund becomes equal to the paid-up capital.

Besides this 'Reserve Fund', many banks provide out of profits 'Secret Reserves', 'Dividend Equalisation Fund', 'Reserves for bad or doubtful debts' etc., which serve practically the purpose of a Reserve Fund. These reserves are built out of the appreciation in the value of the bank's securities or in the value of bank's premises etc., which, it is held, are fortuitous profits. It is, therefore, desirable that these fortuitous profits should, instead of being frittered away by the declaration of higher dividend, be utilised for strengthening the reserves of the bank as provision against lean years.

Current Deposits and other Accounts.—Current deposits are those which are withdrawable on demand by cheques ; they are called 'Demand Deposits' in America. In other countries interest is not allowed usually on current deposits, but in our country interest at a nominal rate, say, ¼% is still given as an inducement to depositors. Time is fast approaching when interest on current deposits will cease to exist. Deposits received for a fixed period or certain agreed period of notice are called 'Fixed Deposits'. These fixed deposits are termed as 'Time Deposits' in America. Fixed deposits always earn interest. Besides these, deposits are also received in savings bank accounts, which are withdrawable once or twice a week up to a certain limit. If any withdrawal exceeding that limit is to be made, one week's notice is usually required.

The item 'Other Accounts' includes credit balances in the bank's ledgers, such as balances standing to the credit of unclaimed dividend or unclaimed interest accounts.

Liabilities for Acceptances, Endorsements on Accounts of Customers.—These liabilities devolve on a bank on account of the bills of exchange being accepted or endorsed by the bank on behalf of its customers. These also include the bank's contingent liabili-

ties in respect of confirmed letters of credit, guarantees, unfinished contracts, forward exchange contracts or such other engagements undertaken by the bank on behalf of its customers. All these obligations are considered contingent, as the liabilities will fall on the bank only when the customers fail to honour these obligations. These items appear also on the 'Assets' side, since the customers are liable to recompense the bank for the fulfilment of such engagements by the latter on their behalf.

Assets of a Bank.—The side of assets represents more faithfully the varied nature of the bank's functions. It shows how the funds of the bank are in general being employed. It is upon the judicious selection of assets that successful banking depends. It is to be remembered that a bank ordinarily functions to earn profits for its shareholders. The profits depend upon the yield of the assets. 'Liquidity' describes the capacity of a bank to satisfy demand for cash in exchange for deposits. To satisfy depositors' claims, a bank must be able to convert its assets into cash *quickly* and without loss. The most liquid form of assets is *cash* held by the bank in its own vault. The balance it holds with the Central Bank of a country is also as good as cash and the two are shown together. Next to these, appear the balances with other banks. These constitute the first line of defence for a bank.

'Money at call or short notice' means loans which are recoverable at call or at the expiry of a short notice. In London it comprises loans to the bill-brokers or discount-houses payable at call or seven days' notice, sufficiently backed by eligible collateral securities like first class bills. Such a 'reservoir of short money' adds strength to a bank and proves immensely useful to meet any exceptional demand on a bank. In New York call-loans are usually granted to the stock exchange. But in India as there is no discount-market, loans to bill-brokers are not strictly called 'call loans'. So also loans to the stock exchange. In this category come the loans granted in India from one bank to the other repayable at call. Of course, such call-loans are given to banks of unimpeachable credit and integrity. Whenever any bank has surplus reserves, such call-loans do provide an outlet for earnings as it is well-known that cash is often called an 'idle asset' which yields no income. These loans constitute the banker's second line of defence.

'Bills of Exchange' are short-dated investments of a bank, generally of three months' duration. As such bills mature for payment within a short time, these are readily selected by the bank as securities for advances. Money here has a quick turnover. Moreover, if there exists a well-developed bill market, the bills can be discounted more freely and are thus easily 'shiftable' from one hand to the other. In times of necessity, these bills are also rediscountable with the Central Bank of a country. Bills of exchange, broadly speaking, include Treasury bills, international as well as inland trade bills. In the U.S.A. official statistics make no distinction between loans and discounts. Discounts are shown under 'Loans and Advances'.

'Investments' are made in Government securities, municipal bonds, industrial shares, debentures etc. They yield a fixed income and bring a steady profit to the bank. When the demand for bank loans falls off, the bank chooses to invest its funds in the above types of securities and when it increases, it meets the demand by realising its investments.

Advances to Customers.—Advances to customers represent the bank's loans to its customers against approved securities. Such advances include secured as well as unsecured advances. These constitute the primary sources of income to a bank. According to Dr. Walter Leaf, these advances form the 'central portion of the activity of a bank'. From the standpoint of commercial banking, advances should be made for a short period. Liquidity should be the primary consideration for a bank while making advances by way of loans, overdrafts or cash credits. A banker is to use the utmost caution in making advances and must have to temper liberality with caution.

Liabilities of Customers for Acceptances, Endorsements etc.—For the discharge of these liabilities the bank is to be properly recomposed by its customers, on whose behalf these responsibilities have been undertaken. These are contra entries to the similar items on the liabilities. So they cancel each other.

Bank Premises.—These are the fixed assets of a bank, which we may call the least liquid item. In order to arrive at a proper valuation of these assets, depreciation is allowed periodically.

At the end is appended a specimen form of the balance sheet prescribed under Section 29 of the Banking Companies Act, 1949.

Banking Ratios

Banking is an evolutionary concept. So is banking practice. It will not be wrong to say that banking practice preceded, in fact, banking theory and the principles of banking, which were discovered long before they received theoretical recognition, were essentially derived from practical considerations gained in the course of day-to-day business. It is admitted that banking principles are dynamic and the banker is to adapt his policy to suit the credit requirements of an ever-changing world, but it is equally true that he has to follow certain ratios while employing his funds with reference to the quantitative distribution of his assets so that the position of the bank is adequately safeguarded and the interests of the depositors properly served. Ratios in banking can be likened to the instrument panel on the dash-board of a motor car. They show whether lending is too fast for safety, or too slow to maintain progress, whether the money that oils the wheels of commerce is flowing as it should and whether the ammeter is showing a rate of charge or discharge.

It does not necessarily follow that the maintenance of the accepted banking ratios is the sole guarantee for the safety of a bank. If the quality of the assets of a bank is of an unsound character, even the meticulous observance of the accepted banking ratios cannot save a bank from a crash. Besides this, bank ratios, which are suitable for one country, may not suit the other, as the conditions of the two may differ. Likewise ratios which will fit in well during a period of prosperity may fail during a period of depression. So the dynamic economic forces at work at different times and in different countries should be taken into consideration in studying banking ratios.

Usually three cardinal principles, *viz.*, safety, liquidity and profitability, guide the credit policy of a banker. From the point of view of the liquidity of a bank the most important ratio is the proportion of cash to deposits. English banks usually keep cash resources of 10%, which is the customary standard. In India which, unlike England, possesses neither a well-developed cheque system, nor large units of banking, a higher cash ratio will be desirable. In our country there are seasonal variations in the cash-holdings of banks. These holdings reach their maximum in the

slack season culminating in August-September and attain the minimum level in the busy season about the months of February-March. The average cash ratio, as maintained by the Indian scheduled banks during 1947, varied from 10.45% to 14.99% and that of banks submitting returns under the Banking Companies Act during 1949 from 10.9% to 14.3%. In 1952 and 1953, the average cash ratio of the Indian scheduled banks moved round 10%, rose to 12% in 1954 and later declined to 10% in 1955.

Next comes money at call and short notice. In England the 'Big Five' kept about 6% of their deposits under this item as on 31st Dec., '37. Indian banks, with the exception of a few, did not publish separately in their balance sheets the amount of money at call and short notice until 1950. But it is understandable that the figure will be comparatively low, as the call loan market is not well-developed in India and is restricted to a few important financial centres only. As at the end of 1955, money at call and short notice amounted to Rs. 9.5 crores only.

Bills constitute another form of liquid assets. These are self-liquidating documents with a definite maturity. English banks invest about 10% to 15% of their deposits in the purchase of bills. But in India a very low percentage is invested in this item. On an average, bills purchased constitute 6% of the total deposits of a bank. The absence of a bill market in India is keenly felt. Unless such a market is fostered, the bill habit in India will not be properly formed.

English banks invest about 30% of their deposits in first class securities like British and Colonial Government Bonds. Although the consolidated ratio for Indian scheduled banks is nearly 50% under this head, still it cannot be denied that smaller banks have very low investments under this item. In this connection, the following extract from a circular dated 1-9-38 issued by the Reserve Bank of India is worth quoting:

> "It is difficult in the variable conditions of India to state definitely what should be the minimum limit for holdings of securities but ordinarily in the absence of an open market for first class commercial bills it would not seem desirable for commercial banks to hold less than 30% of their time and demand liabilities in the form of either cash or approved securities of ready marketability and

an even greater margin would seem desirable unless their business is of a very liquid nature."

Under Section 24 of the Banking Companies Act it has been stipulated that every banking company in India shall maintain in cash, gold, or unencumbered approved securities valued at a price not exceeding the current market price, an amount which shall not at the close of business on any day be less than 20% of the total of its time and demand liabilities in India.

Thus it will be observed that cash, money at call and short notice, bills and investments, taken together, will vary from 50% to 60% of the deposit liabilities of the English banks. The advances of the British banks bear a ratio varying from 40% to 55% to deposits. In India although the average of advances for scheduled banks varied from 40% to 50% in 1949, the ratio varies very greatly from bank to bank. A characteristic feature of the balance sheets of the Indian scheduled bank is that they are required by law to show the secured, unsecured and doubtful advances, as well as the advances to Directors separately. It would be difficult to prescribe a ratio of unsecured to secured advances. But it is desirable that the percentage of unsecured advances should always be kept at the minimum level.

In Great Britain the proportion of paid-up capital and reserves to deposits before the war stood at 10% but has now shrunken to about 6% owing to a considerable increase in deposits. In India the paid-up capital and reserves of the Indian scheduled banks bore to deposits a proportion of 13.5% in 1935, 12.9% in 1936, 12.9% in 1937 and 13% in 1939 while the ratio declined to 9% in 1949 and further to 8% and 9% in 1954 and 1955 respectively. It still further came down to 5% in 1959. Of late, there is a move on the part of Indian banks to raise fresh capital and to make larger allocations towards reserves so that their paid-up capital and reserves constitute at least 6% of their total deposits.

Commercial and Central Banking Legislation and Control

Almost all the countries, with the exception of a few, have adopted comprehensive legislation for the regulation of commercial banking for the protection of the interests of the depositors and

shareholders. Such a legislation, in common, attempts to define banking with reference to the specified operations to be discharged by banks, provides for the licensing of banking establishments, lays down the nature of powers of bank directors and managers, prescribes the legal minimum ratios of paid-up capital and reserves to total liabilities, the obligations to build up sufficient reserves, formulates certain regulations regarding the employment of the bank's own funds against specified securities or assets, calls for certain returns from the banks showing their position and provides for the inspection and examination of the books and accounts of the commercial banks by instituting, if necessary, a suitable machinery of control.

Directors and Management.—Certain countries through legislation prohibit bank directors from participating in other occupations as in Denmark. Any kind of loan to Directors is totally forbidden in Belgium, Turkey, and Norway, limited as to amount in Chile and is made subject to the consent of the Board of Directors in Denmark, of shareholders in Greece and of the Office of Control as in Germany and Italy. In India under section 10(1) (*c*) of the Banking Companies Act no banking company shall be managed by a person who is a director of any other company, not being a subsidiary company of the banking company, or who has a contract with the company for its management for a period exceeding five years at any time. In terms of Section 16 of the Act no banking company incorporated in India shall have as a director any person who is a director of any other banking company. Again under section 20(1) no banking company shall make unsecured loans or advances to any of its directors or to firms or private companies in which any of its directors is interested as partner or managing agent or to any individuals, firms or private companies where any of the directors is a guarantor.

Capital and Reserve.—The legal minimum ratios of paid-up capital and reserves to total liabilities have been prescribed in the following countries:

ECUADOR	50%
BOLIVIA	33%
CHILE	25%
GERMANY	20%

TURKEY	14 to 33%	(according to funds)
SWEDEN	12 to 20%	(according to funds)
DENMARK	10%	
NORWAY	10%	
SWITZERLAND	5%	

The minimum proportion of net profits to be transferred to the Reserve Fund has been fixed in different countries as follows:

INDIA	20%
SWITZERLAND	5%
TURKEY	5%
NORWAY	20%

Liquidity of Banks.—The principles of liquidity have been laid down in three principal ways:

(*a*) by defining the cash assets and fixing the minimum cash-ratio between such assets and the outside liabilities ;

(*b*) by stipulating what kind of assets may or may not be acquired ; and

(*c*) by regulating long-term credits and loans.

The first two groups of provisions relate to primary (cash) and secondary (liquidity) reserves. Cash-reserves include till money and balances with the Central Bank. Liquidity reserves comprise easily realisable short-term papers and securities guaranteed by the state and public credit institutions.

In some countries only cash ratios are enforced, which vary according to the amount of capital as in Denmark and the importance of the locality as in the U.S.A., and also acccording to the proportion of short-term to total liabilities as in Switzerland. The system of varying the cash-ratios by a central bank according to the condition of the money-market and as a complement to open-market operations is in force in the U.S.A., New Zealand, Sweden and Australia. In countries like Bulgaria, Denmark, Portugal and Switzerland both cash and liquidity ratios have been established, while in Finland, Norway and Sweden a mixed type of ratios is in force.

The maximum credits allowable to a single customer will be 10% of a bank's own funds in the U.S.A., China, Turkey etc.,

whereas in countries like Italy, Greece, Bolivia, Norway and Denmark the limit varies from 20% to 35%.

Loans against the collateral security of a bank's own shares are forbidden in Canada, Chile, Finland, India etc. or made subject to the consent of the Office of Control as in Norway.

Regulations regarding real estate and mortgage business are generally restrictive. In many countries investment in real estate is forbidden.

With the notable exceptions of India, New Zealand, the U.S.A. and South Africa, central banks in other countries are rarely invested with the power of supervision and control over banks, although they are well represented on the Controlling Body.

In Australia the banking system has been brought under effective control by means of regulations under the National Security Act of 1939-40. Those regulations took effect from the 26th November, 1941. The principal provisions of those regulations are given below:

A person or Corporation (other than a bank in the Commonwealth or of any state) cannot carry on any banking business without authority in writing from the Governor-General, who can withdraw any authority, if he likes.

Control of advances is sought to be achieved by requiring the trading banks to comply with the advance policy of the Commonwealth Bank of Australia. Accordingly, a Memorandum has been issued by the Central Bank to the trading banks restricting credit to genuine trade requirements.

Any trading bank is to obtain the prior consent of the Commonwealth Bank in order to purchase or subscribe to Government, semi-Government or municipal loans or securities listed on any stock exchange. A trading bank is further required to keep in a special account with the Commonwealth Bank, such parts of its surplus investible funds as desired by the Bank, in accordance with a plan of the Treasurer and cannot withdraw those deposits without the permission of the Commonwealth Bank. Those deposits earn a stipulated rate of interest as determined by the Treasurer.

The bank is subject to periodical inspection by the Auditor-General who is to submit the report of inspection regularly to the Treasurer and the Commonwealth Bank.

As regards the control over central banks, three types may be distinguished:

(*i*) Governments appoint all the members of the Board of Directors as in New Zealand, India and Germany.

(*ii*) In countries like Argentine, Denmark, France and Italy, Governments, besides providing for their own representation in the management of the central banks, take increasing interest in the selection of such Board as will be representative of various interests.

(*iii*) The independence of the Central Bank is kept unimpaired.

Noticeable changes have been introduced by widening the powers of central banks in respect of rediscounting facilities or advances against collateral security in three principal ways: (*a*) by making eligible for rediscount certain types of paper not possessing the traditional qualities of security and liquidity, (*b*) by authorising the central banks to accept new types of securities as collateral security for advances, and (*c*) by empowering the central banks to make more or less direct industrial and commercial advances.

The Bank of France was authorised by the Government in the year 1936 to rediscount Treasury bills and Special bills drawn against grain harvests, and guaranteed paper secured by stocks of wine.

Under the Regulation of 1937 the Federal Reserve Board of the U.S.A., approved for discount finance paper, construction loan notes and consumer's paper. The same regulation specified certain securities as eligible for investment by national banks, loans on certain stocks, mortgages, notes issued under the National Housing Act, debentures and bonds issued by Federal Home Loan Banks or under the authority of the Federal Farm Loan Act. The new regulation thus "bars no paper from use as collateral for advances, but merely indicates a class of preferred paper which covers all the principal fields of financing".

The extension of more or less direct industrial and commercial loans by the Central Bank has been authorised in three countries, *viz.*, the U.S.A., Italy and New Zealand. In the U.S.A., the Act

of 1934 empowered the Federal Reserve Bank to discount or buy from any bank, trust company, mortgage company, credit corporation for industry or other financing institution obligations maturing within five years and entered into for the purpose of advances to industrial and commercial enterprises.

Another noteworthy trend in central banking development is the *extension of the powers and control* of the Central Bank over the commercial banking system and the [illegible] countries by the adoption of the following methods: (*a*) open-market operations, (*b*) variations in the cash ratios of member-banks by the Central Bank, (*c*) variations in the fiduciary note-issue, (*d*) process of off-setting of gold and foreign capital movements.

The open-market operations take any one of the following forms: (*a*) open-market operations in the accepted sense of the term as adopted in Great Britain and the U.S.A.; (*b*) open-market operations in Germany are restricted chiefly to the purchase of securities as a supplementary cover for the note-issue; (*c*) those of the Bank of Poland are confined to the employment of the Bank's own capital.

Variations in the cash ratios of commercial banks are enforced by the Central Bank in the U.S.A., New Zealand, Argentine, Belgium and Australia. The Reserve Bank of India has also been recently invested with similar powers.

Variations in the fiduciary issue of the Central Bank form another method of control. In the United Kingdom there took place several alterations in the maximum fiduciary issue from £260 million in 1928 to £275 million in 1931, £260 million in 1933 to £200 million in 1936 and to £400 million in 1939. Similar variations took place in Japan in 1931, in Sweden in 1933 and in Norway in 1936 to meet the altered circumstances.

Provisions regarding legal cover constitute an important feature of recent legislation. Besides the fixed fiduciary-issue, minimum legal reserves are fixed in different countries, for example 25% against notes and sight liabilities in Canada, New Zealand and Argentine. In India the Reserve Bank of India Act provides for a minimum holding of Rs. 400 crores in foreign securities and of Rs. 115 crores in gold in the Issue Department of the Bank.

MIXED BANKING

After the first World War there was a significant departure from the traditional principles of commercial banking and a drift towards mixed banking. The relaxation of the conservative codes of commercial banking practice was partly the result of the post-war depression and partly the result of changes in the general economic organisation. Commercial banks found it increasingly difficult to employ their swelling deposits in ordinary commercial transactions and were forced to engage in business hitherto considered to be outside their legitimate sphere with the result that there was a marked shift in the trend of bank credits from shorter to longer term account and an increasing participation on the part of commercial banks in investment banking. This tendency towards mixed banking is not without its advantages to industry as will be evident from the history of German banking. The combination of banking functions yielded good results in Denmark and Switzerland. Mr. Whale observes that "the industrialist is in contact with the bank through his ordinary banking connection in the investment market. The bank knows his business intimately; it can help him with the capital he requires for its development either by undertaking an issue of shares and debentures immediately or by making an advance in mitigation of such an issue at a later date ; it can advise even as to the outlook in the investment market, and finally when an issue is made, its influence with the investing public goes far to ensure the successful placing of the securities". If the capital and reserves of a commercial bank are relatively large in proportion to its deposits, and if a considerable portion of the deposits constitutes time deposits, a portion of these funds may perhaps be employed in the long-term financing of industry. According to Dr. S. K. Basu, the risks involved in such form of financing may be considerably reduced by pursuing a cautious and judicious policy of carefully selected investments and by working in syndicates. Among industrial securities high-grade bonds having a wide and active market may be chosen and the machinery of valuation must be highly improved to guard against defective valuation when advances are made on the security of block of industrial concerns.

The system of mixed banking is not free from defects. These

defects are exposed in times of depression when the value of investments depreciates and the banks find a considerable portion of their assets frozen and unrealisable. This was what exactly happened in America, France, Japan etc., during the depression of the early 'thirties. Often the policy of long-term investments is apt to be carried beyond the limits of safety. In France the Banque Nationale de Credit collapsed in 1932 owing to an excessive investment in industry, while the difficulties of the Austrian Creditanstalt arose from its imprudent participation in industrial financing. The American banks too got inextricably involved in real estate loans and long-term bonds which proved absolutely unrealisable and had to close their doors in scores.

The crisis created by an intermixture of banking functions produced a reaction in different countries against mixed banking and prompted legislators to bring about a segregation between commercial and investment banking. Under the American law, commercial banks are to divest themselves of all the interests in any investment affiliate and must eschew all issuing and underwriting activities. In Belgium all deposit banks were prohibited from taking up shares or participating in commercial or industrial enterprise from the 1st January, 1936. In Sweden banks were restrained under the Bank Act of 1933 from acquiring shares and lending on security except under certain specified conditions. In India too certain restrictions have been imposed on banks as regards acquiring controlling interests in non-banking companies. According to scetion 19 of the Banking Companies Act, a banking company shall not form any subsidiary company except a subsidiary company formed for one or more of the following purposes, namely, the undertaking and executing of trusts, the undertaking of the administration of estates as executor, trustee or otherwise, the providing of safe deposit vaults or, with the previous permission in writing of the Reserve Bank, such other purposes as are incidental to the business of banking. Save as provided above, no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves whichever is less. Further a banking company shall not, after the expiry of one year from the date of the commencement of this Act, hold shares whether as pledgee,

mortgagee, or absolute owner, in any company in the management of which any managing director or manager of the banking company is in any manner concerned or interested. Under section 9 of the Act, no banking company shall hold any immovable property howsoever acquired, except such as is required for its own use, for any period exceeding seven years from the acquisition thereof or from the commencement of this Act, whichever is later.

After the Second World War every country is engaged in the task of rebuilding its economy for which huge funds are required. Even in the U.K. which is wedded to strict commercial banking principles, there is a growing awareness of the need for commercial banks to provide finance for the rehabilitation of its industries. In that context, a banking expert of that country observes as follows:—"The scale under modern conditions on which finance is required to cover future planning has now reached the point where only the banks command the necessary resources. This fact is being increasingly recognised. In America, the banks now grant what are called 'term credits' and facilities of a similar character are provided by many banks on the Continent. These arrangements undoubtedly conflict with the principles on which the U.K. banks have been so firmly and successfully established and I would not put forward any suggestion for a modification of those principles, if I thought it would in any way impair the strength, stability and flexibility of our banking system. Nevertheless, by virtue of the very strength which they have achieved and in view of the need to cover the finance required for expansion and development in industry vital to our national economy, I believe they would be well advised to consider the desirability of a limited departure from their existing practice. In broad terms, it is my considered opinion that the banks might well examine the possibility of granting fixed-term loans for this purpose, with a maximum of five to ten years, to an aggregate amount limited to some proportion of their total advances. Such loans should be strictly confined to objectives designed to benefit the national economy and conditioned that the required finance could not be obtained through any of the existing channels." In India banks are showing greater interest in providing term finance in the context of planned development and generally observe the norm that such finance does not exceed 5% of their total resources.

bank-deposit, *i.e.*, a claim against the bank. This virtually means an increase in the debts of the bank, and since the debts constitute money, the supply of money is increased by the loanable amount. At the same time the assets of the bank increase by the amount of the loan. The same thing happens when a bill is discounted by a bank and the proceeds are credited to the account of the client, which leads to an increase, by the discounted amount, of the bank-deposits, *i.e.*, debts of the bank to the client. In this case the income of the bank represents the value of the bill *minus* the amount discounted. Another way of adding to its debts on the part of a bank is when the bank purchases securities by drawing a cheque on itself, *i.e.*, giving a debt in exchange for the securities which become part of its assets.

Having regard to the capacity of the bank for the creation of money or purchasing power, Hartley Withers holds that 'loans make deposits' and that the initiative in the creation of credit lies with the bank. The borrowers are free to withdraw their loanable funds, credited to their accounts by the bank, and transfer the same to some others. Those 'others' may have accounts with the same bank, in which case the funds so withdrawn are likely to be deposited with that bank or if they are customers of some other bank, they may choose to deposit the money so received with their own bank. In any case, as long as a loan is due, a deposit to that amount will remain outstanding in some other bank or banks. According to Rt. Hon. Reginald Makenna, the dictum that 'every loan creates a deposit' is technically correct but its implications are limited. The statement holds good with regard to loan but not to permitted overdraft which does not itself create a new deposit (Vide *Bankers' Magazine*, December, 1942—'What is banking?').

Dr. Walter Leaf in his book on 'Banking' has raised a strong objection to the above theory. Dr. Cannan also joins hands with him in the same objection. According to them, it is wrong to say that the initiative in the creation of credit lies with the bank ; it will be more in accord with truth to say that the initiative, in the ultimate analysis, will lie with depositors whose money is loaned out by the bank. They further maintain that the bank is in a position to lend, simply because the depositors do not withdraw their money all at a time. Consequently, certain unwithdrawn deposits remain which can be lent out by a bank. Hence there is

no essential distinction between a bank and a cloak-room. Suppose in an evening party some hundred invited guests assemble and it is known that the party will not break up before 9 p.m. The guests, one by one, deposit their cloaks with the cloak-room attendant. The attendant keeps with himself 15 cloaks and lends the remaining 85 cloaks, to be returned before 8-30 p.m., on this idea that some guests may leave earlier. In such a case can it be said that the attendant created 85 cloaks? So they observe that banks do not create credit at all. Besides this, Dr. Leaf points out from an analysis of the balance sheets of the 'Big Five' that during the first months of 1926, though the advances of the banks had increased largely, their deposits actually decreased ; so it will be wrong, in his opinion, to say that loans make deposits.

Let this controversy be considered with reference to an isolated community having no foreign trade. Further it is assumed that there is only one bank in that country, with which all the inhabitants keep their accounts, and that no cash circulates, as all transactions are settled by cheques there. Under these assumptions loans will create deposits in the manner pointed out before. But in real life such an isolated community is non-existent. In order to bring it in conformity with realities, let the above hypothetical assumptions be removed one by one. Be it, therefore, assumed that some cash is necessary to meet the obligations of the people in addition to the cheques used. Further, it is understood that instead of one bank operating, many banks are functioning and the people keep their accounts with different banks. In that case, every bank will be delivering cheques on the other and likewise be receiving cheques drawn on itself. In other words, it will be having cheques in its favour as well as against itself and it is unlikely that the two shall always balance. Every bank will, therefore, have to keep certain cash reserves to honour cheques presented by the other banks. These cash reserves bear a certain proportion to the total deposits of the bank. When the cash reserves exceed that acceptable proportion to deposits, the bank is in a position to lend more freely ; when the reserves fall short of that fixed ratio, the banks will have to curtail loans. Thus, it is observed that the policy of loan is guided by the considerations of the aggregate reserves a bank should possess in relation to its total deposits.

The creation of credit on the part of a bank is subject to the following limitations:

1. The necessity for keeping adequate cash reserves to meet its obligations. If loan is extended more freely, that will deplete the cash reserves of the bank and the bank cannot extend loans beyond the limits of safety, which are ordinarily determined by the adequacy of cash reserves.
2. The total reserves of the banks as a whole determine what should be the limit to lending. And these total reserves depend on the policy of the Central Bank, which is capable of increasing or diminishing the cash reserves by appropriate measures, like open-market operations and manipulation of the bank rate.
3. A bank will agree to lend credit only when the securities offered are found acceptable. If approved securities are not available, the bank cannot create credit without inviting dangers. Naturally the availability of good borrowers as well as of good securities sets limits to the creation of credit on the part of a bank. Sayers observes rightly that "the banks put this newly created money into the hands, not of everybody at once, but of those individuals who can offer to the bank the kind of asset which the bank thinks attractive." (Sayers: *Modern Banking*, p. 17).

On the whole, the bank possesses the power to create credit subject to certain restrictions, which represent the safety-measures for the existence of a bank.

Unit Banking vs. Branch Banking

The distinction between unit banking and branch banking is too patent. The former is an example of carrying on banking business through a single office and the latter through more than one office. Unit banking is another name for localised banking and branch banking for de-localised banking. The United States of America still retains some of the original features of unit banking, *i.e.*, banking restricted to a single office, though supplemented by the 'correspondent bank system', which, in a small measure, combines some of the advantages of branch banking. According

to the correspondent bank system, a country bank in the U.S.A. is able to open accounts with bigger banks operating in the cities like New York, Chicago, St. Louis, etc., transmits funds through them from one city to another and collects various instruments drawn on those bigger places. Thus some of the advantages of branch banking may be derived from the 'correspondent system' without the expenses involved in having a separate branch office. So, while comparing branch banking with unit banking, it is to be remembered that unit banks do not stand by themselves alone, but are linked with the correspondent bank system. England, Canada, South Africa, Australia are examples of branch banking, *i.e.*, of banking institutions having large numbers of branches throughout the length and breadth of those countries. A comparison between unit banking and branch banking is essentially a comparison between small-scale and large-scale operations.

The disadvantages of unit banking are, generally speaking, the advantages of branch banking and vice versa. The advantages of branch banking may be considered from the following standpoints:

1. Branch banking possesses the advantages and economies of large-scale operations, in which the applicability of the division of labour or 'specialisation' looms large. Generally speaking, banking institutions are capable of commanding large resources because of their having branches in more than one place, and as such are in a better position than unit banks to apply effectively the principles of specialisation by employing better types of men on better salaries, engaging right men in right places, and distributing work in such a manner that the abler employees are spared the time and energy of devoting whole time to the broader problems of bank management, such as the forging of the banking policy, the selection of securities against which advances may be made with safety, devising ways and means for the improvement of the methods of organisation and account-keeping of the bank, proper distribution of assets of the bank under various items, staff-management and recruitment and other kindred matters connected with the policy-making of the bank. Though it cannot be said with precision that branch banking holds the monopoly of the advantage of enforcing 'division of

labour' vis-a-vis unit banking, still there is little room for doubt that the scope for the applicability of 'specialisation' in unit banking is comparatively limited.

2. Branch banking offers the advantage of managing with lower cash reserves in each office. The economy of reserves thus ensured by branch banking, is a vital consideration for a banker. That one branch can draw upon the other in order to replenish its reserves in times of necessity, shows that each office can do with lower cash-reserves in normal circumstances. This advantage can be derived by a unit bank as well, when linked with the correspondent system, by drawing upon its deposits with the correspondent bank ; but such a procedure is likely to be unremunerative, as the deposits with the correspondent bank yield little or no return.
3. Branch banking has the advantage of effecting remittances of funds from one place to another at a lesser cost than unit banking. The element of cost is an important consideration for the public to choose between banks. People will be going to that bank which can offer services at a lesser cost.
4. Risks can be spread geographically by the system of branch banking more effectively than by unit banking. Banks operating through branches distribute their assets in different places like putting eggs in different boxes instead of in a single box, and thus can diffuse and minimise the risk of loss or failure. In this respect unit banking suffers from a great risk in the sense that if owing to some unforeseen reasons, the business in a particular locality is adversely affected, the assets of a unit bank, localised in that place, may depreciate in value to such an extent that the bank may be faced with a serious crisis as its assets are all concentrated in that affected locality. But a bank having its other branches, may stand well such a shock by realising the assets lying in other places, not so affected. A contrast was provided by the British banks, wedded to the system of branch banking, and the American banks retaining some characteristics of the system of unit banking, during the depression of 1929. At

that time several thousands of American smaller banks were swept off their feet by the chronic depression persisting in certain sectors of American agriculture, as their assets were mostly localised in the affected places, while the British banks, operating through branches, could meet such a crisis, even though their branches were hard hit by heavy losses in the Lancashire Cotton Industry, by making profits in other prosperous areas or by the realisation of assets lying in the unaffected parts of that country. In India also the same phenomenon was discernible during the communal disturbances in the East and West Punjab. Banks like the Central Bank of India, the Punjab National Bank, which have numerous branches spread all over India, could easily cushion the shock of the disturbances in the Punjab which shattered almost to pieces its economy, as they had enormous assets diffused over other places beyond the borders of the Punjab. But banks like the Traders' Bank, the New Bank of India etc., which had their assets concentrated in the disturbed places of the Punjab, were badly affected and had to be given succour by the Government of India by the declaration of a moratorium in their favour for the time being.

5. Branch banking has the merit of mitigating the disparities in the rates of interest ruling in different localities, and of equalising those rates over wider areas, by effecting movements of funds from one office to another. The difficulty in the movements of funds is a potential cause of the differences in the rates of interest and if it can somehow be overcome by quickening their movements, the rate of interest will tend to gravitate towards a uniform level. If it is possible to arrange for the movements of funds into a place where they are shy, from a place where they are abundant and easy-flowing, and if that arrangement can be kept going, the differences in the rates of interest between the two places will naturally shrink. In this manner the wider and quicker will be the movements of funds from one place to another through branch-banks, the more readily will the rate of interest fall to a uniform level and come to equality.

6. The free movements of funds, which are possible through branch banking, will, in the end, add to the profitability of banking operations, as the funds lying idle in one office may be transferred to another office, where they are in great demand, for the purpose of investments there on a better yield or return. This will reduce to a minimum the funds which lie idle and provide for them an outlet for better utilisation and return elsewhere. Thus branch banking will ensure a quicker mobilisation of funds in times of emergency, as well as more profitable seasonal movements of funds from places where they are in surplus, to places where they are tight.
7. Branch banking offers a wider scope for the selection of diverse securities and varied investments. If it is once decided that investments should be made against securities of one type or the other, a bank having numerous branches can choose such investments and securities on better terms with greater convenience than an independent unit bank. Suppose that a decision is taken to make advances against stocks and shares, it will be more convenient to implement such a decision by advancing money through that office of a bank, which is nearest to a Stock Exchange where stocks and shares are dealt in. Such a step will help to maintain the safety and liquidity of the advances inasmuch as the securities may promptly be disposed of because of the nearness to the Stock Exchange. Besides this, a branch-bank can sprinkle its advances over several businesses which are independent of each other—a service which a unit-bank cannot render.
8. Sometimes it is said that branch banking is less expensive in the sense that a branch can be run by a comparatively small personnel and that 'a less pretentious building and less expensive equipment may be used in a branch than in the case of an independent unit-bank'. It is debatable how far this view is true and it is difficult to make a generalisation on this point. This might be true in a very restricted sense but when establishment expenses of all the branches are taken into consideration, it is hard to believe that this statement can stand analysis.

9. Another argument in favour of branch banking is that by having branches in the different parts of a country, it is possible to have a deeper knowledge and a more intelligent grasp of its economic problems by virtue of one's accessibility to the otherwise uncharted realm of the habits, behaviour, customs and conditions of the people inhabiting those localities, and thus to form a more complete picture of the condition of the country. Branch banking in a manner is capable of offering diversified services according to the needs of the different localities of the country and is in a position to serve the country better by bringing its intimate knowledge of the country to bear on its services. It thus helps to raise the standard of banking by sharpening their knowledge and judgment.
10. Finally, it is argued that branch banking provides the best training ground for those people desirous of making banking their career. In branches it is easier to understand the different processes of banking, which enable a trainee to comprehend in the end their niceties and complexities. There much groundwork can be learnt and done and it is less difficult to trace the origin of banking work, and to follow its connected processes leading to final disposal.

Disadvantages of Branch Banking which mean Advantages of Unit Banking

1. Just as, according to Adam Smith, "the division of labour is limited by the extent of the market", so is branch banking (which ensures an increasing application of division of labour) by the market for its services, which is not necessarily limited by national frontiers. Once the frontier is crossed, branch banking has to invite certain disadvantages, emerging from divergences in laws, business customs, conditions, monetary units etc., from country to country. This has reference to branch banking in foreign countries in particular.
2. Branch banking presents the difficulty of efficient management, supervision and control. It is really very difficult to exercise control, supervision and vigilance over too many

branches in an effective manner. And for lack of supervision, control and inspection, a branch bank may go astray. So unwieldy branch banking is fraught with the dangers of mismanagement or incompetent management.

3. Branch banking is undeniably expensive. With the opening of too many branches, establishment and maintenance charges of the branches are bound to mount high and as a result, profits may shrink. Besides this, as the branches become far-flung and widely scattered and the business increases in volume as a whole, the costs of co-ordination and centralised control over branches rise high.
4. Each branch is a potential source of weakness, as a run on one branch may precipitate a general run on the whole institution. But as against this, it may be cogently argued that each branch is a potential source of strength in the sense that a run on one branch may be speedily met by mobilising all the resources of the rest of the branches.
5. Under the unit banking system, a failure of a bank removes once for all a weak spot. But under the branch banking system a weak branch may be permitted to continue like a festering sore, which may gradually be eating into the vitals of a bank and may, without warning to the public, bring it slowly to the brink of virtual collapse. Thus branch banking acts as a smoke-screen for hiding the weaklings instead of exposing them to the public eyes.
6. Branch banking is often associated with the charge of red-tapism, and delay in the disposal of urgent matters, which are to remain pending till reference to the Head Office of that branch. Besides this, it may happen that funds may have to be transferred to headquarters at the latter's direction even at the sacrifice of the local interests. Such an act not unoften gives a handle to such criticism that banks from outside come to take and not to give.
7. Branch banking when kept within limits confers certain benefits but when it overshoots its mark and degenerates into indiscriminate branch opening, it brings in its wake over-banking with its accompanying evils of cut-throat competition, rate-cutting, offering of excessively high

rates for attracting deposits and propensities to risky investments.

8. It is often argued in favour of unit banking that its manager has a better opportunity of having a direct personal knowledge of the local business men, their business integrity, credit, means and their business morality and as such is in an advantageous position to judge which particular business man may with safety be accommodated. But even such knowledge does not always act as a check, as, according to Sayers, 'the individual banker may have been too unwilling to refuse a loan to the incompetent or dishonest scion of a family with which his father and grandfather had been on intimate social terms'. But, on the contrary, Sayers remarks that a branch bank manager is in a better position than a unit-manager in this respect, since he is to refer each proposal for sanction to his Head Office and so 'if there is occasion to refuse a loan, he can always thrust the unpleasant ones to that remote abstraction Head Office without running so much danger of terminating his social contacts with the clients'.

On the whole, it will be observed that the arguments weigh in favour of branch banking and that branch banking is the result of a normal and logical phase of banking development in a particular country. In the U.S.A., branch banking was restricted by national and state banking laws, presumably inspired by the traditional fear of a 'Money Trust' and banking there was sought to be anchored to the unit system, supplemented by the 'Correspondent Bank System' of which we spoke before. But during the last few years there has been a notable change in the old unit system and a drift towards branch banking. The National City Bank of New York is permitted to open branches in foreign countries and the Federal Reserve Banks have been allowed to start branches in their districts. The development there has taken the form of chain and group banking whereby a number of banking institutions located at different places is brought under one unified control, sometimes through stockownership of those banks and sometimes through interlocking of directorates and offices and in other cases by the acquisition of the majority of stocks of each bank through a holding

company and 'thereby creating a system of banks more or less integrated in management with the Central Bank of each group'.

BRANCH BANKING IN INDIA

India being a sub-continent, it is imaginable how vast will be the banking requirements of this amazing country. Branch banking so far evolved in India is too inadequate to touch the fringe of the problem and is yet to be developed in the right direction to meet the requirements of the teeming millions. It is estimated that in India there are only 2·5 banking offices per million of population—a sad contrast with other leading countries of the world. Of the 2,500 towns in India inhabited by only 6% of the total population, barely 400 of those towns have a bank or a branch of a bank. Those people living in the villages are virtually without any banking facilities whatsoever. With reference to the number of branches and pay-offices of the scheduled banks in India, which increased from 720 to 1,138 in 1938, Sir James Taylor, the then Governor of the Reserve Bank of India, observes that "branch banking is developing in India on an increasing scale, though it is obvious that much further progress in this direction will be necessary before India can have a network of joint-stock banks adequately covering the country." Since then there has been a further increase in the number of banking offices rising to 3,573 up to 31st March, 1947 though complete statistics of the offices of the non-scheduled banks are not available. Taking the scheduled and non-scheduled banks together the total number of their offices is estimated at 6,000 compared with 1,800 at the end of 1939, representing an increase of 300 per cent. These figures do not include banks having capital and reserves below Rs. 1 lac or offices of money-lenders and indigenous bankers. On the whole there is an enormous scope for the development of branch banking in India and in it lies the solution of meeting the banking needs of the people. But unfortunately, taking advantage of the inflationary monetary conditions during the last war, many of the banks, specially non-scheduled banks, developed a pernicious tendency 'towards too rapid an expansion of branch banking, without careful preliminary prospecting in each case in the light of existing facilities, the size of available business and the likely changes therein and reasonable earnings'. The

development of branch banking that has so far taken place is, as it appears, lop-sided, because of an undue concentration of banks in large towns and cities. While the number of banking offices has shown a very rapid increase since 1939, the number of places formerly not served by banks to which banking service has been extended is comparatively very small. Of the new offices of scheduled banks opened since 1939, only about 300 were reported to have been opened at places which were not previously served by any bank and there are still about 1,100 urban centres in India which do not boast of even a single banking office. The inadequacy and uneven spread of banking in the country is revealed by the fact that there is only one banking office for every 70,000 of the population and that 2,396 offices were located in 175 towns having a population of 50,000 and above and 2,681 offices in 1,379 places having a population of less than 50,000. It is necessary that instead of opening branches at centres where adequate banking facilities already exist and thereby entering into unhealthy competition with the existing banking offices, banks, when they are in a position to open new branches, should do so at centres which require them and are without any banking facilities. The Government of India were greatly concerned with this aspect of development of banking during the war-period and they, therefore, enacted the Banking Companies (Restriction of Branches) Act, 1946 (since repealed by the Banking Companies Act) to restrict the opening and removal of branches by banking companies in India without getting the prior sanction of the Reserve Bank of India in writing. In India the rural areas should be brought within the ambit of organised banking, for which purpose attention is to be devoted towards extending banking facilities to those areas. In future the pay office system of branch banking deserves an experiment in India because of its widening usefulness to the rural people and of its low expense-ratio. The small agriculturist, the handicraftsman and the small local traders who are generally the victims of the money-lenders require to be relieved. Their small deposits should be productively utilised. If the indigenous bankers doing business in rural areas can be trained up once in the methods of modern banking, it is recommended by some thinkers that they should be entrusted with the functions of acting as regular branches of the other joint-stock banks on the German 'Kommandit'

system in the rural areas. The Rural Banking Enquiry Committee went into the question of expanding banking facilities in rural areas and have recommended, *inter alia,* that the Imperial Bank of India (now the State Bank of India) should extend its branches to the taluka or tehsil towns where they do not exist at present and where the volume of Government business and business potentialities warrant such expansion and that the commercial banks and co-operative banks should be arranged to open branches in taluka towns and smaller towns.

BANK AMALGAMATIONS

Although India has a few big banks, the average size of our banks, specially of non-scheduled banks, is still too small to enable them to employ the right sort of personnel or to operate on accepted lines. Because of the smaller resources and limited paying capacities, these banks cannot operate on the same lines as big banks in regard to their loans and advances with the result that they have to undertake unsound and risky business, rejected by other banks of better standing. It is not meant thereby that there is no scope for small banks in our country. There are a few small banks rendering useful services in the countryside and it is in the general interest that these banks should be encouraged to continue their useful existence. But a bank by its very nature must have a minimum size and minimum resources to enable it to operate profitably both for itself and also from the point of view of the interest of the locality in which it functions. For this purpose it would be necessary that banks in India should amalgamate themselves on a large scale in the same way as the banks in the United Kingdom were amalgamated at about the beginning of this century. Instead of having too many weak banking institutions with meagre resources, it is always preferable to have a few such institutions, strong and stable, with sufficient resources and a network of branches spread all over the country.

In England the joint-stock banks of London absorbed a large number of private bankers in the countryside in order to start branches there and those in towns outside London, absorbed London private bankers with a view to opening offices in London. The process of amalgamation proceeded at a breakneck speed and

assumed alarming proportions in course of time. As a result of such amalgamation the 'Big Five' of England came to the forefront of banking. It was for a time feared that such an absorption would concentrate the monopoly of banking and finance in the hands of a few banks, which might then be prone to misuse their powers and influence. And accordingly a Committee was formed in the year 1918 in England to report on the effects of such amalgamation on trade, industry and commerce and also to examine whether any legislation would be necessary to check such absorptions. The Committee reported at that time that amalgamations should be allowed only after the approval of the Treasury and the Board of Trade was obtained. Though no legislation was passed, a convention has since grown up under which banks desiring amalgamations do approach the Treasury for sanction of such schemes and refrain from doing so if the schemes are disapproved by the Treasury. The net results of such amalgamations have proved rather beneficial in the end, as has been amply demonstrated by the solid structure and organisation of the English banks. Usually the desire for amalgamation is inspired by the economy of management, the adequacy of banking resources that would be obtainable, possibility of better management with the services and experience of the trained personnel already on the staff-list of the bigger absorbing bank, and other kindred advantages that would usually flow from large-scale operations. Besides these, amalgamations help to establish uniformity of practice and may prove a 'source of strength during emergencies and periods of financial peril'. Moreover, amalgamation smooths the way for taking a concerted action in the banking sphere, should any occasion so arise, as the number of banks to be dealt with is reduced thereby. The easiness and speed with which a concerted action could be taken by the British Government during the second world war, by bringing the banks under the increasing control of the Government to meet the war-time emergency, amply demonstrate the truth of this statement. Though amalgamation might have some incidental disadvantages, as are common to big combinations and monopolies, *viz.* concentration of financial power and control in a few hands, political corruption, speculation, over-trading and fleecing the public by virtue of their monopolistic position etc., still amalgamation, if conducted on right lines and in an altruistic spirit,

possesses sufficient potency to do more good than harm. Our country, which is a land of small banks, must have to resort to amalgamation to build up a few strong banking units and to stabilise the banking structure in general. This will make branch banking easy and accumulate sufficient credit to be lent out to trade, commerce and industry. Further, it will help to rationalise our methods of banking business, perfect the banking technique, reduce the unevenness in the interest charges at different places, standardise commissions and fees over vast areas and provide a corrective to the haphazard and ill-balanced loaning methods of the existing small-scale banking institutions. In order to guide the amalgamation movement in India on the right lines the Reserve Bank of India should hold the steering wheel. Under Section 44A of the Banking Companies Act no bank amalgamation can take place in India without the sanction of the Reserve Bank of India. The Reserve Bank has made it clear that it does not sanction any scheme of amalgamation unless it is satisfied that it is not detrimental to the interests of the depositors of any of the amalgamating units. Nor can the banking companies concerned enter into any such agreement unless the proposal is formally approved by two-thirds of the shareholders present at a special meeting convened for the purpose. In December 1950 a few scheduled banks in West Bengal finally amalgamated under the name and style of the United Bank of India Ltd. with the approval of the Reserve Bank. In 1951, there was a partial merger of the Bharat Bank Ltd. with the Punjab National Bank Ltd. and under that scheme the Punjab National Bank took over the entire liabilities in respect of deposits in the Indian Union of the Bharat Bank against the transfer of equivalent assets comprising cash, Government securities, approved advances etc. The notable success of these two schemes, which averted a major banking crisis in West Bengal and Northern India, does not necessarily indicate that the process of merger or amalgamation is the universal remedy for solving the financial difficulties of banks in trouble. Amalgamation of intrinsically sound banks into larger units would certainly contribute to the stability of the banking structure and it appears to be the policy of the Reserve Bank to encourage this development as far as possible. This process is, however, practicable only in the case of a sound bank or in the case of a bank the realisable assets,

of which cover its outside liabilities but which is likely to be in difficulties owing to fortuitous circumstances or to the fact that its assets cannot be realised within a reasonable period. In the case of such an institution, a bigger bank may be prepared to take over the assets and pay the depositors out of its own resources, if necessary. The transfer of the liabilities and certain assets of the Mercantile Bank of Hyderabad Ltd. to the Hyderabad State Bank and of the Maharastra Apex Bank Ltd. and the Southern India Apex Bank Ltd. to the Canara Industrial and Banking Syndicate Ltd. are instances in point. No banking institution can, however, be persuaded to agree to take over the assets and liabilities of an unsound bank when the transaction is likely to result in a loss.

It has been the objective of the Reserve Bank to bring about merger or amalgamation among banks on a voluntary basis. The provision for voluntary amalgamation (Section 44A of the Banking Companies Act) was, however, availed of only to a limited extent. Following the failure of two scheduled banks whose financial position was extremely vulnerable and a short-lived run on some other banks a few small banks began to manifest signs of weakness. It was, therefore, considered necessary that suitable provisions should be included in the Banking Companies Act, 1949 to deal with such a situation if it should recur. Section 45 of the Banking Companies Act which came into force with effect from the 19th September 1960 empowers the Reserve Bank of India to apply to the Central Government for an order of moratorium in respect of a banking company where it appears to the Reserve Bank that there is good reason to do so. The Central Government may thereupon grant a moratorium to the banking company for a period not exceeding six months. It is also provided that if during the period of moratorium the Reserve Bank is satisfied that

(*a*) in the public interest ; or
(*b*) in the interests of the depositors ; or
(*c*) in order to secure the proper management of the banking company ; or
(*d*) in the interests of the banking system of the country as a whole,

it is necessary to do so, the Reserve Bank may prepare a scheme for the reconstruction of the banking company or for the amalgamation of the banking company with any other institution. The new

section authorises the Reserve Bank to frame schemes of amalgamation or reconstruction without the formal approval of their members or creditors. The Reserve Bank is also empowered to effect a reduction of the interests or rights which the members, depositors and other creditors have in or against the banking company to such extent as the Reserve Bank considers necessary in the public interest or in the interests of the members, depositors and other creditors or for the maintenance of the business of the banking company. Several banks have thus been compulsorily amalgamated under the new provision of law.

CHAPTER III

CENTRAL BANKING

It is now universally recognized that the Central Bank should possess the exclusive right of note-issue with a view to exercising unimpaired control over the money market. It is why that the other banks are deprived of the power of issuing notes. The argument for the Central Bank having the monopoly right of note-issue is inspired by the fact that it must control the banking system by being the ultimate source of *cash*. If other banks are allowed to issue notes, the Central Bank will be prevented from enforcing its control over other banks as the ultimate creator of cash. The notes issued by the Central Bank represent cash, which constitutes the assets of the other banks. So by a variation of the note-issue, the Central Bank can, to a large extent, influence the assets side of the other banks. In a broader sense, note-issue is an important device for controlling the aggregate supply of money in a country. It is expanded or contracted according to the currency needs of a country in certain circumstances, subject to certain conditions.

The Central Bank acts as a banker to the State. The Government receives and disburses enormous sums through taxation and expenditure policy, which, if left unregulated and unco-ordinated, will generate forces, inimical to the stability of the money market. Hence the financial operations of the Government, for the sake of the stability of the money market, are canalised through the Central Bank, which undertakes to regulate the flow of receipts and outflow of payments according as the money market permits. Thus the Central Bank acts as the custodian of Government funds. Besides this, the Central Bank is the financier of the Government in times of necessity. It is well-known that the revenue-receipts of the Government are unevenly distributed while its expenses are continuous. The Central Bank may be approached for helping the Government in such a contingency by making 'ways and means' advances. These advances are wiped out as soon as the

revenue-receipts are deposited by the Government in its account with the Central Bank. Moreover, it is to assist the Government in loan floatations, and to advise it on the market conditions and other financial matters. The Government is to seek advice from the Central Bank, which, because of its intimate contact with the money market, is better able than others to advise as to whether the money market conditions are favourable for the absorption of the Government's contemplated new loans or for the conversion of the old loans at certain rates. The Central Bank, on behalf of the Government, manages the public debt, which is an important section of the Government's financial policy. Again when the Government is in need of short-term finances, the Central Bank assists it in tiding over the temporary financial stringency by issuing Treasury Bills at the opportune moment. The Central Bank thus functions as the custodian of Government funds, as well as the lender and financial adviser to the Government.

The Central Bank operates further as a bankers' bank and as a lender to them in the last resort. It is a bankers' bank not only in the sense that it keeps the accounts of other banks, but also helps them, in times of emergency, by rediscounting their bills of exchange, promissory notes and other commercial paper or granting advances against approved securities. But the latter obligation is discharged, only when the commercial banks have exhausted all other means of raising the required advances from other sources and are left with no other alternative but to approach the Central Bank for help. This is what is meant by the phrase 'lender of last resort'.

If the Central Bank is to properly discharge its obligation as a bankers' bank, it must have to avoid entering into competition with other banks for business as well as for profits. Any competition with other banks is derogatory to the Central Bank's authority over them. By virtue of its position the Central Bank is to look after the interests of other banks; any such act, on the part of the Central Bank, which hampers the business of these banks, in a competitive spirit, will weaken the banking structure of a country. "In the interest of smooth working of the system, there should be an atmosphere in which mutual help is possible at any time." Having regard to this principle, the Bank of

that country usually keep $4\frac{1}{2}\%$ of their deposits as cash-reserves with the Bank of England. But in the U.S.A., India, New Zealand, Canada and other countries cash reserves are to be kept with the Central Bank as a statutory obligation. The reasons for such compulsory statutory deposits are the following: *Firstly*, statutory cash reserves with the Central Bank provide it with control over the credit policy of the other banks. *Secondly*, such deposits add to the resources of the Central Bank. *Thirdly*, the requirements of such compulsory deposits impress on the banks the necessity for keeping their position liquid and provide them with certain reserves, which they can draw upon in times of difficulty.

The Central Bank has the supreme duty of controlling the volume of credit and keeping the credit structure stable. How this function is discharged by the Central Bank will be discussed later. In addition to these, the Central Bank performs a useful function as a clearing house of other banks. In the preamble to the Reserve Bank of India Act the main functions of the Central Bank have been defined: 'to regulate the issue of bank notes and the keeping of reserves with a view to secure monetary stability in India, and gnerally to operate the currency and credit system of the country to its advantage'.

Central Bank's Control over the Money Market

If the financial stability of a country is sought to be maintained, the Central Bank must have full powers to control the money market to the best advantage. To achieve this objective, both exchange stability and internal price stability of the country are to be ensured by the formulation of a correct policy by the Central Bank. It has already been pointed out that banks can create credit subject to certain conditions. If the Central Bank can control the volume of credit, which is capable of being created by commercial banks, it can help a great deal in the establishment of internal stability. In its ultimate analysis, as creation of credit by banks depends upon their cash reserves, the Central Bank can control it if it can exercise control on the cash reserves of those banks. As the Central Bank is the ultimate source of cash by virtue of its possessing the monopoly of note issue and the minting

of coins, it can certainly vary the cash reserves of the banks, which will govern the creation of credit by those banks.

Control of Cash.—Cash is of two kinds, *viz.*, (*a*) the acceptable form of money into which the claims of banks are convertible, *i.e.*, all legal tender money ; (*b*) Bankers' deposits with the Central Bank of that country. Let us take the case of the Bank of England, which is the Central Bank of Great Britain. 'If the Bank of England can determine the volume of Bankers' deposits with itself, and can supply whatever volume of notes is appropriate to that level of Bankers' deposits the Bank of England will be controlling the general operations of the commercial banks.' (Sayers). Bankers' deposits are changed by the Bank of England by the (1) purchase of Treasury Bills in the market ; (2) purchase of gold from the market ; (3) an excess of payments to the Government over payments by the Government (*i.e.*, rise in public deposits).

While the Bank of England purchases Treasury bills or Government securities in the open market, it injects into circulation so much money, which will fall into the hands of the public, who will then deposit, if not the whole, a certain quantity of it with their respective bankers, which will result in an increase of Bankers' deposits. The result is to generate expansionary conditions in the money market. With command over increased cash resources, the banks will be lending out their funds more freely and extensively and in this way will be creating more credit. The same result will emerge from the purchase of gold. In the third case, public deposits will rise, but will lead to a decline in the Bankers' deposits. With the depletion of Bankers' deposits, they shall have to work on low cash reserves, curtail advances which will bring about a contraction of credit. This mechanism is termed 'open-market operations'. Thus it is observed that the Central Bank is in a position to influence the Bankers' deposits and the total supply of money. When the Central Bank can vary the cash reserves and deposits of the other banks in the above manner, these banks may, in times of necessity, approach the Central Bank for succour, and the Central Bank will agree to render help at its own rate and under its specified terms and conditions. Such a state may be described by saying that the Bank rate is effective. As soon as the Bank rate becomes effective, the Central Bank has a complete grip over the money market.

Variable Reserve Ratio

In countries where the money market and the capital market are ill-organized or non-existent, increasing recourse is now had to variable reserve ratio as a new weapon for credit control. Lord Keynes recommended the application by a Central Bank of the hitherto unused weapon of varying the reserve ratio of member banks and went so far as to suggest that the Bank of England should be empowered to vary the cash reserves between 10% and 20% in respect of demand deposits and between 0 and 6% for time deposits. Cases may happen when the Central Bank finds itself short of the securities, which are to be offered for sale in the market, and also finds it unremunerative to buy securities from the market when the price is high. In such circumstances it will be convenient if the Central Bank possesses the requisite power to ask the member banks to keep a higher and lower percentage of reserves against their deposits. Suppose, the member banks go on extending credit on liberal terms when in possession of surplus funds, the Central Bank, if it desires a contraction of credit, may ask the member banks to keep a much higher cash ratio than the scheduled ratio and thus compel them to restrict credit. 'Whereas the other two methods (bank-rate and open-market policy) are designed to bring about an actual quantitative change in reserve holdings, and thereby in free reserves, a change in the reserve requirements serves to create or destroy free reserves by a stroke of the pen'.

The United States of America is the first country to adopt this instrument of monetary control. Under the Banking Act of 1935 the Federal Reserve System was authorized to alter the cash ratios of the member banks within certain limits. During 1936 and 1937 the Federal Reserve System raised the reserve requirements of the member banks by the full amount permissible by law in order to combat credit expansion. In April, 1938, the reserve requirements were reduced but were again raised to the legal maximum in November, 1941.

In New Zealand, the Reserve Bank could with the authority of the Minister of Finance alter the reserve ratio of trading banks from time to time as a means of maintaining effective control over the credit situation. In Belgium, the Banking Commission

reserved the right to alter the ratios. The Riks Bank of Sweden was empowered by the Government to call upon joint-stock banks, which own funds in excess of 5 million Kronor, to hold their compulsory reserves of 25% against sight liabilities only in the form of till money balances with itself and sight claims on foreign banks and to prescribe at will the minimum proportion of balances with itself to total reserves. The Bank of Mexico can vary the reserve ratio of private banks from 5% to a maximum of 50% of deposits. The Reserve Bank of India has also been vested with powers to vary the cash reserves of the scheduled banks within certain limits.

Countries, which have ill-organised capital and money markets and an inadequate supply of securities, may profitably adopt the variable reserve system as a technique for controlling credit. But in countries like Australia, New Zealand and South Africa, which maintain large liquid assets in London, the variable reserve-ratio system will be shorn of its effectiveness so long as the banks are able to substitute their London assets by increased domestic assets with the Central Bank. But in Canada, which is not required to keep large assets in London because of its having a well-developed domestic money market and is usually accustomed to maintain a suitable reserve ratio between 9.5% and 11.4%, there is a strong case for the variable reserve ratio. But in the case of the above countries Mr. Plumptre has suggested that the requirement of a variable minimum ratio in relation to liquid assets as a whole rather than between cash and deposits would be a more effective weapon'.

This system is not without objections:

1. It is held that the variable reserve ratio lacks precision not only in respect of changes in the amount of reserves, but also in respect of the place where these changes are to be made effective. The changes in reserves involve few larger sums than in the case of open-market operations.
2. It affects banks differently. Banks with large reserves will be little affected while banks with small reserves will be hard pressed.
3. Changes in the reserve requirements may not be adjusted to meet 'small and localised situations of reserve stringency

or superfluity', as had happened in New York and Chicago in 1942.

4. The system is likely to exercise a depressing effect on the security market. If the banks are required to maintain a higher cash ratio, they may do so by selling their securities, which will have the effect of depressing the security market.
5. It is often said that this system will endow the Central Bank with sweeping powers over the member banks. In order to use this technique prudently, the Central Bank should, as Keynes suggests, alter the ratio with due notice and in small degrees.

It is a common idea with many that the reserve requirement imparts liquidity to other banks. But this idea is now obsolete, for liquidity is seldom achieved by this system. Progressive views favour the integration of the two policies, *viz.*, open-market operations and variable reserve ratio, and recommend their joint application.

Bank Rate

The Bank rate is the rate at which the Central Bank will rediscount bills of exchange or promissory notes and grant advances on approved securities. In a sense, it is called the discount rate, but, in a broader sense, it means the advance rate of the Central Bank of a country.

When it is said that the Bank rate has become effective, it does indicate that the Central Bank can impose its own terms and conditions being a lender of last resort and the ultimate source of cash. Such a situation is described technically by the phrase, "the market is in the bank." The Bank rate has been evolved as a potent weapon for credit control by the Bank of England. The efficacy of the Bank rate was demonstrated by the Bank of England. This is the official rate which is fixed every Thursday by the Court of Directors of the Bank of England or on special occasions at a special court. The Bank rate is normally above the market rate and as such it may be called a 'penal rate', for the rediscounting facility can be had from the Bank at a higher cost than the one ruling in the market. As a result, the market rate will also follow

suit by going up. For, 'the discount houses having to secure money at usually high rates will only discount new bills at rates which will compensate them for the high cost of obtaining the money'. This delicate and beautiful instrument of Bank rate is used by the Central Bank for operating on the internal situation as well as on the external situation.

When it is observed that a country's balance of trade has turned adverse resulting in the export of gold for meeting the adverse balance, and thus the gold reserves of the country are depleted, the Central Bank, to control such a situation and to offset the outflow of gold, will raise the Bank rate. Such a step will influence the internal prices and interest rates and balance the balance of payments without recourse to gold exports. The immediate effect of a rise in the Bank rate will be reflected on the foreign exchange. Since the Bank rate is high, the foreigners will feel tempted to retain or utilise their funds in that particular country because of the higher return obtainable. Further they shall find an inducement for transferring their funds from elsewhere for the purpose of investment in that country in expectation of a better return. There will be an inflow of funds into that country and the outflow will be readily checked. The demand of the foreigners for that particular country's currency will increase and so its value will rise in terms of foreign currencies. Thus the exchange rates will become favourable. In consideration of a higher Bank rate, borrowing will be less, as the country then becomes dearer for borrowers, leading to a contraction of business activities, which will, in turn, generate a deflationary tendency in the market resulting in a fall of money-incomes and the price-level. In consequence of a low price-level, exports will be stimulated and imports from outside discouraged. This will bring about a favourable balance of trade. Thus a change in the Bank rate influences the foreign exchange market through the short-term money market, the long-term capital market as the changes in the short term rates spread to the long-term market, and lastly the balance of trade. But such a result will not be automatic unless the country affected [illegible] market for [illegible] funds and the lending [illegible] in the [illegible] foreign exchange [illegible] [illegible]

development if there are channels for the loan of short money, and there are borrowers or guarantors who command international credit-worthiness. And Sayers says that in great centres and small alike, the borrowers whose credit-worthiness secures international recognition are the leading commercial banks with whom the money may be deposited The soundness of the bank is not so much a consideration as its international reputation. British discount houses and banks command world-wide reputation and unimpeachable credit. So England has developed such a market to her best advantage. Sayers aptly remarks that the banks of Latvia and San Salvador may be perfectly good, well-run, and paying institutions, but unless foreigners have such confidence in them that they are ready to deposit funds with them when a rate differential appears and widens, the Bank rate is ineffective in regulating the flow of short-term funds. The people must have confidence in the stability of that currency ; otherwise a difference in the rate will be no attraction for outsiders to invest funds in that country. The fact that the people are hesitant and have fears is sufficient to neutralise the effect of the Bank rate.

In the summer of 1931 when England was faced with excessive withdrawals of funds from London, the outflow could not be checked in spite of the short-term rates rising far above the levels of New York and Paris. People were then very much pessimistic about the financial stability of the British Government. In France also a similar rise in the Bank rate failed miserably to control the situation in 1923-24 and 1933-36 ; rather the rise aggravated the French budget-deficit. Before the enhanced Bank rate could generate any deflationary tendency in the money-market, the increasing budget-deficit might lead the authorities to have recourse to inflation. So Sayers observes: 'Little wonder then that when we read in the papers that Paris had put up the Bank rate we took it as a signal that devaluation was one step nearer'. Sometimes it is argued that the lender can protect himself against exchange risks in the forward exchange market. But the difficulty is purely psychological. When the people once develop a psychology of currency-fall, it will be an exceedingly onerous task to arrest it by arranging cover. Such a step gives rise to extreme discounts and premiums in the forward exchange market outweighing the probable differences in the interest rates.

Still, however, operations in the forward exchange rate by the Central Bank will lend a strong support to the Bank rate in controlling the external situation, for the Bank rate should not be taken to be omnipotent in all circumstances. Externally, the Bank rate influences the relation between incomes and costs at home and abroad and thus affects the balance of trade. Let us now examine how the Bank rate influences the internal situation of a country.

When the Bank rate is raised, the business men who are on the margin of doubt as to whether it will be lucrative to invest in business, will be discouraged from borrowing money because of the higher rate. People who borrow funds for constructing docks, factories, buildings etc., will be induced to contract their activities in view of the higher cost of borrowing. The production of investment goods will slow down leading to a slump in the constructional industries. Because of the sharply decreasing spending power, the prices will tend to fall. The traders and dealers, who used to stock goods so long with borrowed funds, will, in anticipation of a falling price-level, reduce borrowing money as also stocks. They will also curtail their orders for articles to producers who in their turn will quote lower prices to the dealers precipitating a fall in the wholesale price-level. But the costs of the producers including wages do not fall. So they are to carry the burden of rising costs in the face of a falling price, until the burden becomes too heavy. Naturally they will be forced to curtail the productive activities, and a general slump will ensue with the inevitable consequence of unemployment. As such a state persists the costs and the money-incomes will come down. The reverse will happen when the Bank rate is lowered.

There are two lines of thought regarding the way in which the changes in the Bank rate influence prices and production. The first line of thought is represented by Mr. Hawtrey who holds that the change in the Bank rate, having direct bearing upon the short-term rate, influences the activities of dealers who hold stocks of finished and semi-finished goods. As the Bank rate is raised, the short-term rate also rises ; it adds to the cost of holding stocks and the dealer, in order to avoid the increasing costs, will be reducing stocks. In its ultimate analysis, the reduction of stocks will indicate reduced purchases by the dealers. Producers will find their sales falling off and will be compelled to curtail production

and output. With reduced output, factors of production will be less employed and consequently money income will shrink. This contraction of money incomes leads to a decline in retail sales, and to reduced purchases from dealers. Symptoms of deflation become visible in the market and the producers, being depressed, will postpone replacement of and addition to plant, which will affect the production of capital goods as well.

Conversely, if short-term rates fall, the cost of holding stocks becomes lower, which encourages the dealers to increase their stocks by buying more rapidly. This will bring increased orders to the producers, who will feel an urge to expand their activities by employing more factors of production. As a result, money incomes will rise and the inflationary tendencies will be generated. The forcefulness of the above argument will depend on (*a*) the proportion which interest charges bear to the total cost of holding stocks, and (*b*) the elasticity of demand for the convenience of holding stocks.

Lord Keynes holds that the Bank rate influences the internal situation, not through short-term rates but through long-term rates affecting the willingness of the entrepreneurs to hold fixed capital goods, such as factories, machines etc., and to replace the worn-out machines and plant. The higher the rate of interest, the less attractive is any form of capital extension and the lower the rate, the more is it likely that the entrepreneurs will be undertaking capital extension. A change in the short-term rate will lead to a change in the long-term rate in the same direction for the following reasons. If the short-term rates rise, while long-term rates remain the same, short-term securities will prove more attractive to investors and bankers. As a result long-term securities will be sold for the purpose of purchasing short-dated securities. It is an axiom that as the price of a long-term security falls, its yield rises which means an increase in the long-term rates. So it is observed that a rise in the short-term rates will lead to a rise in the long-term rates and *vice-versa*.

Changes in the long-term rates will affect the investment market. The volume of investment in fixed capital goods has a direct relation to the prospects of profits being earned, in which long-term rates play an important part. The amount of profits remaining the same, the higher the long-term rate of interest, the

less attractive becomes any form of new investment or replacement of existing capital. Entrepreneurs will be spending less on capital goods, as a result of which employment in capital goods trades shrinks and the total money-income diminishes. Consumers, in their turn, will be saving less and less and partly reducing expenditure on current consumption. Production and employment in the consumption goods trades decline. Capital investment in these trades becomes less attractive and the activity of the capital goods trades shrinks even further.

But in actual life the state of trade and prices are not so responsive to the rate of interest policies. 'Bitter experience has shown that the state of trade, although it does appear to respond eventually to dear or cheap money, responds painfully slowly'. The efficiency of the long-term interest policy depends on the elasticity of demand for capital. The more elastic the demand, the more quickly effective will the policy be. But in all times of extreme trade conditions like depression, when no amount of reduced interest will stimulate new production, and in times of boom when things look so rosy that an increase in the rate will not deter any entrepreneur from some investment, the business man's demand for capital may be somewhat inelastic.

On the whole, both these lines of thought start from the same hypothesis of banking policy having influenced the cost of holding goods. Their difference lies in the class of goods affected by the Bank rate and is primarily a difference of emphasis only.

Limits of the Bank Rate

As has already been said, the Bank rate is not to be considered as a panacea for all ills in the money and capital markets. The Bank rate has its limitations and may not produce the desired results in all circumstances. Changes in the Bank rate, not accompanied by similar changes in other rates of the money market which differ from each other, may not introduce any variations in the loan policy of the banks. If the Bank rate is raised, it will be followed by a rise in the market rate. But there is no certainty that there will be a fall in money rates, but its power to force a fall in the money rates is very much limited. A Central Bank

can give support to inflation in the market by a variation in the Bank rate, but it cannot prevent a slump in the market.

Moreover, a change in the interest rate affects the cost of borrowing to a business man, which forms a small part of the total cost of production. So the influence of the Bank rate on cost of production is restricted. This is also amply proved in times of depression and boom, when variations in interest rates are matters of indifference to the producers. Wherever the Bank rate has been successful in producing certain results, it could do so by throwing the capital market into disequilibrium and creating for the time being a disturbed state of trade. As Sayers observes, "If we want to deflect our money-income structure by a high Bank rate, we have to produce a depression by damping down capital development, throwing people out of work, and upsetting the state's finances, in the hope that one day the pressure of employment will lead to lower wage-rate and other money-incomes becoming the rule. And conversely. Although the Bank rate may always have its uses, the future lies not with those who would rely on a refurbishing of the Bank rate, but rather with those who are prepared to add more weapons to armouries of monetary authorities".

The following are the reasons for the lack of effectiveness of the Bank rate in the U.S.A.:

1. Absence of conventional relationships between the official discount-rate and certain money-rates.
2. The existence of surplus gold reserves during the greater part of the year.
3. The wide scope and strong inclinations for speculative activity in the U.S.A.
4. The lack of independence on the part of the Federal Reserve Bank in the matter of fixing discounting rates.
5. The rate of discount is not higher than the market-rate, as is the practice with the Bank of England. In the U.S.A. it should be a penal rate.

The limitation of the Bank rate may also be attributed to the following factors:

1. The bill of exchange as an instrument for the financing of domestic trade has since declined.
2. Development of competing international money markets has limited the utility of the Bank rate.

3. Predominance of the short-term Treasury bills.
4. Abundance of liquid funds in the money market is not helpful towards the smooth and efficient working of the discount-rate policy.
5. The scope of a discount-rate policy was narrowed by an increased rigidity in the economic structure. A substantial measure of elasticity in the economic structure is required for the success of this policy, *i.e.*, prices, wages, production and trade should respond to changes in money rates and credit conditions.

Keynes considers that the equilibrium between investment and saving should be attained by means of the state organisation of investment, or failing this, by compensatory planning of public works rather than by means of the Bank rate policy.

Wagemann points out that, while 'the discount rate can influence production through its influence on long-term interest, it can do so more quickly through the short-term credits which play an important part in the financing of production'. He emphasizes that the influence, which the discount policy may exert over the capital market through the money market, is usually felt only after a lag of four to six months.

The discount-rate policy should be applied in the right time, since the trend of business and speculative activities cannot be reversed after they have attained a certain momentum. It is often suggested that the internal credit situation should be controlled by an internal rate and the external situation by an external rate. But such a division of the credit situation of a country into rigid water-tight compartments is not possible, because one influences the other. Likewise suggestions are made to control speculation by differentiation of rates, chargeable for business and for speculative purposes. This policy was practically adopted by the Federal Reserve System in the U.S.A. in 1928

According to Burgess, the influence of a discount-rate change is psychological, which is more important than its direct influence. This psychological influence is largely dependent on the prestige of the Central Bank and the extent of co-operation between it and the commercial banks. In South Africa the commercial banks change their advance rate according to the changes in the Reserve Bank's discount rate.

Open Market Operations

In addition to the Bank rate, the open market operations are often undertaken by the Central Bank to exercise a stabilising influence on the money market. Open market operations signify those transactions of sale or purchase of securities on its own initiative by the Central Bank to control the volume of credit in the market. As for example, when the Central Bank finds a surplus of reserves in the hands of joint-stock banks, which inspires the latter to enter upon a policy of credit expansion and the Central Bank thinks this expansion policy, from a long-range view, prejudicial to the ultimate stability of the money market in the context of circumstances that are likely to develop, the Central Bank will at once come forward to sell securities in the open market and take off the surplus reserves with a view to checking that tide. As the securities are sold, the intending purchasers will be drawing cheques on their respective banks, which will deplete the cash reserves of the joint-stock banks, which will then be persuaded to curtail extension of further credit to stop drainage on their reserves. As a result, the volume of credit will be diminishing. Similarly, when the Central Bank will note that the money market is tight and lending is very much restricted, it will, if it considers restoration of easiness in the money market suitable, be purchasing securities from the open market. As the securities are purchased by the Central Bank, money will be coming into the hands of the public in an increasing flow, which the public will be depositing with their bankers. This will augment the bankers' deposits and their cash reserves as well, and inspire them to lend more freely and extensively. Thus the tightness in the market will be overcome. The open market operations policy is an effective weapon in the armoury of a Central Bank to control the money market.

This policy takes different forms in different countries. In England it has become a custom with the joint-stock banks not to borrow directly from the Bank of England by rediscounting their bills with the latter. When the Bank of England undertakes sale of securities, and the cash reserves of the other banks are depleted, those banks will be curtailing their commitments, and recalling the advances they made to the bill-brokers or the discount houses. They will be replenishing their cash reserves by

credit restriction. But in the U.S.A. this result does not automatically emerge. There the member banks, instead of by credit-restriction or the recalling of advances, may replenish their cash reserves by rediscounting their bills with or taking advances against approved securities from the Federal Reserve Bank. Thus credit restriction may not be enforceable in such a contingency. So in the U.S.A. a convention has been established against large and continuous borrowing from the Federal Reserve Bank. A limit is assigned to each member bank beyond which it cannot draw. As the limit is exhausted, each member bank is to keep its cash position intact by curtailing advances and recalling loans. In the U.S.A. increasing use was made of the open market operations. There the Federal Reserve Bank desiring to cause a contraction of bank credit will, instead of raising the discount-rate, sell securities in the open market. In New York, the open market operations are used to initiate the movement in rates, generally the change in the official rediscount rate coming at the end of the process, and scarcely doing more than registering an accomplished fact. But in London, open market operations are apt to be used rather to make an existing official rate effective in the discount market as the general structure of bankers' rates moves with the official rate. Besides the advantage of the direct access on the part of the member banks to the Federal Reserve Bank for borrowing, the member banks in America are to maintain legal minimum cash reserves, which are alterable according to changed circumstances, unlike in Great Britain where the banks are to keep customary cash reserves. So in America, as the securities are purchased by the Federal Reserve Bank in the open market, member banks may wipe out from their increased deposits, their indebtedness to the Federal Reserve Bank, and lower their interest rates. The rates of interest in the market having actually fallen, the official rate is in response thereto reduced by the Federal Reserve System, that change being the last, and not as in England, the first stage of the operation. In order to make the open market policy effective, a flat rate of cash reserves is desirable. Thus for the success of such a policy of open market operations, the existence of a Board and well-organised capital market and the maintenance by commercial banks of a stable cash ratio are necessary. In Australia open market operations were not so successful, because

the market for Government securities was narrow and the commercial banks are wont to maintain unstable cash ratios. This is why the Commission on Australian Banking recommended the establishment of an open market for Treasury bills.

During the war open market operations were intended for preserving a structure of interest rates and for supporting the price of Government securities. Naturally, [illegible] were [illegible] through such operations for increasing the reserve balances of the member banks so that they could subscribe to Government loans. The Bank of England undertook to purchase Government securities during the war, not so much for meeting Government's requirements, as for increasing the cash balances of the commercial banks to meet the increased demand of the public for currency. After the outbreak of the war, there was a remarkable change in the traditional policy of open market operations in England. There the commercial banks did never approach the Bank of England directly for rediscounting facilities, but achieved the said purpose through the intermediary of discount houses. During the war direct contact was established between the commercial banks and the Bank of England, which bought short-dated bills from the clearing banks on the understanding that they would purchase long-dated bills from the discount-market. According to the 'Economist', August 1942, it was 'a curious and highly significant reversal for the traditional machinery of credit control in the country'. In countries like Sweden and Argentine those operations were intended for absorbing the excess of liquid funds in the money and capital markets. In short, the open market operations as adopted by the Bank of England were intended for the following objectives:

1. To make the Bank rate effective or to prepare the ground for a change in the Bank rate ;
2. to avoid disturbances in the money market as a result of movements of Government funds or seasonal movements generally ;
3. to offset the inflow and outflow of gold ;
4. to support Government credit in connection with the issue of new loans or the conversion of existing loans ;
5. to create and maintain conditions of cheap money as an aid to business recovery.

The Bank of England has undertaken open market operations as a supplement to the Bank rate policy. To offset the effect of seasonal movement of funds, the Bank used to buy securities regularly in December, when heavy withdrawals were met before the Christmas, and sold them in January with the return of notes from circulation. It undertakes to buy securities at the time of heavy tax payments and to sell them when heavy disbursements are to be made by the Government. During May, 1938 when substantial funds were repatriated in London, the Bank adopted a new open market technique by announcing that any dealer finding himself short of funds, could sell bills at ½% to the Bank's broker instead of applying for assistance direct to the Bank and this announcement met with good response from the market. The increase in the credit base by way of open market operations has not attained so much success in Great Britain as in the U.S.A.

Open market operations have become one of the potent devices for credit control. The Reichs Bank of Germany was authorised to buy and sell operations in October, 1933. Similarly, the Riks Bank of Sweden was authorised by the Swedish Law of March, 1937. A decree dated June 17, 1938 authorised the Bank of France to undertake open market operations 'in order to influence the volume of credit and to regulate the money market'. The powers to engage in open market operations were included in the statutes of the Central Banks of countries like Argentine, New Zealand, Canada and India from the beginning. The Reserve Bank of India adopted these operations to keep up the value of Government securities and to smoothen the way for the floatation of new loans in the market. In November, 1946, the Reserve Bank of India undertook to purchase directly from the scheduled and non-scheduled banks Government securities to avert a banking crisis which developed in Bengal.

The sales and purchases of securities are undertaken by the Central Bank to 'sterilise' or 'offset' the movements of gold. When gold is imported into a country, it leads to an increase in the reserves of the banks which then embark upon a policy of credit expansion. The Central Bank will then sell securities in the market and take the surplus reserves from the banks which will then be forced to reduce loans and advances. This is called 'sterilising' gold imports. Conversely, when gold is exported the reserves of

banks shrink and the banks contract credit. To stop this, the Central Bank will be buying securities which will increase the Bankers' reserves and inspire them to extend credit more freely. This is 'offsetting' gold. To avert any financial crisis as well, the Central Bank will be purchasing securities, as the Federal Reserve System did during the banking crisis in 1931-32. Keynes has rightly pointed out that the effectiveness of open-market operations is dependent on the power of the Central Banks to have their portfolios stocked with an adequate supply of ammunition in the shape of open-market securities available for sale.

Limits of Open Market Operations

1. In the U.S.A. when sales of securities cause a contraction of the supply of money, the member banks may neutralise this contraction by taking rediscounting facilities from the Federal Reserve Banks. So the desired result may not be produced in the end. When the Federal Reserve System seeks to encourage credit expansion by purchase of securities, the member banks may choose to apply the same to reduce their indebtedness with the Federal Bank, instead of expanding credit.
2. When the Central Bank wants to increase the cash reserves of the banks by purchasing securities, the public might be withdrawing cash from those banks out of panic. At such a stage the desired result may not be obtained.
3. Even if the cash reserves increase, the banks may choose to accumulate the same for meeting an eventuality. In that state expansion of credit will not be possible.
4. Even if the banks choose to expand credit, the business men might feel reluctant to take advantage of the same in apprehension of a depression.

Relation Between Bank Rate and Open Market Policy

Each of the two weapons, *viz.*, Bank rate and open market policy, has its limitations as pointed out above. Each by itself will not succeed in producing the desired results. Each is, there-

fore, to be supplemented by the other in order to be effective. The mere raising of the Bank rate may not always result in a contraction of credit, if certain joint-stock banks possessing surplus funds go on lending at low rates. In such circumstances the Central Bank, with a view to making the Bank rate effective, will be selling securities in the market, which will take away the surplus funds from these banks, and the latter will be compelled to restrict credit. Similarly, if the Central Bank sells securities without raising the Bank rate, the member banks may replenish their reserves by rediscounting their bills with the Central Bank, and thus avoid contraction of credit on their part. So in order to make the open market policy yield the desired results of contraction of credit, it is necessary for the Central Bank to raise the Bank rate, when the banks will find it unprofitable to take advantage of rediscounting facilities.

Open market operations are generally undertaken to prepare the market for changes in the Bank rate, which has a far-reaching influence over the market. It is now being increasingly felt that the Bank rate should be manipulated only when a permanent disequilibrium in the economic life of a country is required to be corrected and not for any temporary maladjustment in the market, which is now sought to be remedied by the application of the open market policy. So it is observed that the efficacy of the Bank rate and of the open market policy is inter-related.

Selective Credit Control and Rationing of Credit

Credit control may be of three types, namely, quantitative, qualitative and selective. The last type of selective credit control is being forged anew in the laboratory of the Federal Reserve System of America. It is intended for preventing a shortage of funds in the securities market and for absorbing the plethora of funds elsewhere. The problem of a Central Bank, in such a situation, is to prevent a decline in the prices of securities without accelerating the inflationary forces. This technique was largely used during the last war and took the form of regulation of margins on securities, as in America the Board of Governors of the Federal Reserve Ssystem under the Securities Exchange Act of 1934 was authorized to prescribe the margin requirements. The Central

Bank intending to ration credit may refuse to rediscount the bills of exchange for a joint-stock bank which directly or indirectly encourages speculation by lending freely. But credit rationing has limited possibilities.

Credit Rationing

Credit rationing was adopted by the Bank of England as an instrument of credit control towards the end of the 18th century prior to the formulation of a systematic discount rate policy and to the assumption of responsibilities by a Central Bank as a lender of last resort. After the first world war the Reichs Bank of Germany raised credit quotas to prevent the collapse of large banks while there was a run on German currency. But this was not without evils, as for lack of credit many firms and industries in Germany had to close their doors.

In Russia rationing by the Central Bank is freely applied as will be evident from the following observation: 'The state bank is guided by another principle in regard to the investment of its inflowing funds, namely, the allocation of funds among financially sound credit aspirants in accordance with a definite plan and at times when the demands for credit exceed the state bank's available resources......the state bank is obliged to divide these funds in some definite way among the enterprises which have need of them'. In short, credit rationing is recommended only in an extraordinary situation calling for extraordinary remedies.

Direct Action and Moral Suasion

Direct action involves direct dealing with the individual banks. The Central Bank may refuse to rediscount the bills of certain banks whose policy goes contrary to the maintenance of stable credit conditions, or refuse to make further advances to certain banks, who are already indebted to the Central Bank. Direct action figured prominently in the report of the Federal Reserve System during 1928-29 when the Board had to grapple with speculative dealings. As Burgess points out, direct action is applied to deal with a few banks who use Federal Reserve credit for too long periods, or in too large amounts. Under the Banking Acts of 1933 and 1935 the

Federal Reserve System was invested with wider powers over the lending operations of member banks. If any member bank is found misusing its credit it may be suspended by the Board from the use of Federal Reserve credit facilities. The Board may further direct any member bank not to increase commitments against stocks or bonds collateral up to one year under penalty and may fix the proportion of such advances against stocks to the bank's capital. This policy aims at the *qualitative control of credit* but is subject to two important limitations: (*a*) the difficulty of deciding at any time and for any bank when there arises an increase of bank credit militating against sound credit conditions, (*b*) the effect of such decision on the part of a Central Bank will be to make the commercial banks slacken their vigilance on their true position and shift to the Central Bank the onus of ascertaining the true position.

Moral suasion creates less unfavourable psychological reaction, as it does not involve any punitive measure or administrative compulsion. Burgess takes the view that 'the Reserve Banks may at times exercise an important influence on the general credit situation through the informal suggestions which they may make to bankers. But unless suasion is armed with statutory powers, it cannot, in the opinion of some, produce any result'. Clark observes that 'persuasion as a means of credit control has not been successful. While at times they no doubt have exerted a restraining influence, the forces making for expansion have proved too powerful for warnings without any teeth in them to be effective'. In the U.S.A. the effect of moral suasion might have been neutralised by the independent policies adopted by thousands of independent unit banks, but in countries like Great Britain where central banking is long established, the Central Bank exercises its moral influence with an appreciable measure of success. In Germany also, moral suasion was successfully applied in many cases. But direct action and moral suasion have their own limitations and, as regards potency, are considered as subsidiary to the discount rate policy and open market operations. In the opinion of Dr. De Kock, for moral suasion there is in general a wider scope than for direct action and in countries where there are highly liquid monetary conditions and where the Central Bank either cannot undertake open market operations at all or cannot do so on a scale sufficient

to counteract the undue liquidity, it is advisable, if not essential, for the Central Bank to use moral suasion as far as possible, in spite of its limitations, while direct action should be confined to special cases, particularly in democratic countries.

The Central Bank issues from time to time directives to the member banks in clarification of the general banking policy, and tendering advice about the nature of investment risks and pitfalls and describing the peculiarities of general market conditions in which prudence and caution should be applied. Thus by persuasion, timely warning and advice, the Central Bank can, to a great extent, influence the credit policy of the member banks. In India, the Reserve Bank, just after the outbreak of the war, advised the scheduled banks to avoid financing any speculative dealings in bullion, Government securities, shares, marketable goods, etc. and fixed appropriate margins to be kept against advances on the security of bullion. Such co-operation between the Central Bank and the member banks is helpful for formulating a correct banking policy and stabilising the banking system of a country. In England and Macmillan Committee observed: 'It is desirable that clearing banks should be made aware in the plainest possible manner whether the general tendency of policy of the Bank of England is towards a relaxation or contraction of conditions of the domestic market'.

Rediscount and Lender of Last Resort

It was in the year 1873 that Bagehot in his book 'Lombard Street' stressed the necessity of a Central Bank undertaking the responsibilities of lender of last resort. The function of lender of last resort was associated with the exclusive right being given to the Central Bank of note-issue, of other general banking business of the Government, which undertake to support the bank in times of emergency. When the Central Bank is called upon to discharge this function of lender of last resort, it does it through rediscounting operations in the main. When the other financial institutions have exhausted all other sources of raising credit to supplement their funds and have failed in their attempt, they are to look to the Central Bank for financial assistance in order to tide over temporary necessity or emergency and the

Central Bank assists them by rediscounting their bills of exchange, promissory notes, and by advancing against their holdings of Government securities, etc. Gradually, the function of rediscounting has come to be regarded as a *sine qua non* of central banking.

Prior to the first world war of 1914, the Central Banks of different countries restricted their rediscounting facilities to genuine trade bills of relatively short maturity, but during and after the war, they relaxed the stringency of measures regarding such facilities and broadened the basis of rediscounts which now apply to Treasury bills, short-term collateral loan etc., commercial bills, agricultural bills and other eligible securities. In a wider sense, rediscounting may be defined as the 'conversion, directly or indirectly, of commercial bank credit into additional central bank credit.' Thereby the elasticity and liquidity of the credit structure may be increased and a considerable degree of economy in the use of cash reserves be effected. As the financial institutions are assured of replenishing their cash resources from the Central Bank by rediscounting in times of necessity, they can conduct a large volume of business with the same reserves or the same business with smaller reserves and capital. The function of rediscounting is made all the more effective than usual, because of the monopolistic right of note-issue and custody of cash reserves being assumed by the Central Bank. The former enables the Central Bank to meet the demand for day-to-day currency and the latter gives more extensive lending powers. But to prevent misuse of this facility as a source of working capital in normal circumstances by any commercial bank, the Central Bank should, in normal times, avoid putting a liberal construction on eligible paper for rediscount. So in the U.S.A., to prevent such a possibility of misuse, it has been officially explained that "under the law a bank is not entitled to credit from a Federal Reserve Bank merely because it has eligible and acceptable paper, if the conduct of the bank's business has been such as to endanger its depositors or to promote the development of unsound credit conditions..........In extending credit accommodation to a member bank, the Federal Reserve Bank is required to consider the general character and amount of the loans and investments of the member bank and whether it has been extending an undue amount of credit for the speculative carrying of trading in securities, real estate, commo-

dities or for any other purpose inconsistent with the maintenance of sound credit conditions."

Rediscounting Powers

The Bank of England works under no restriction whatsoever as to rediscounting. The Bank of France was authorised to discount bills of exchange, *commercial and agricultural* warrants and bills to order with a currency not exceeding three months, bearing two signatures in the case of warrants and bills with approved collateral and three signatures in the case of other bills, and to make advances against French Government, colonial, municipal and specified securities for 90 days. The Reichs Bank of Germany was similarly empowered to discount bills of exchange arising out of *bona fide* commercial transactions or goods with a currency not exceeding three months and other securities. The South African Bank was likewise empowered to extend advances not only against trade and agricultural paper eligible for discount and Government securities including Treasury bills maturing within six months, but also against long-dated Government and municipal securities, more speculative dividend-paying securities easily saleable in the stock exchange, and one-name bills or promissory notes secured by documents of title to staple commodities insured having extensive and active markets.

According to Dr. De Kock, the majority of Central Banks now find that their function of lender of last resort, apart from their relations with the state, is performed mainly in the form of collateral loans to banks and other financial institutions rather than by rediscount of bills of exchange and Treasury bills.

Limits of Central Bank as a Controller of Credit

The capacity of a Central Bank as the controller of credit is limited to the extent that book and trade credits, not derived from bank credit, are employed in business. The power to control credit of a Central Bank is further curtailed because of the fact that not all commercial banks have direct dealings with the Central Bank, as in the U.S.A. more than one-half of the commercial banks with one-fifth of the total resources remain outside the

Federal Reserve System. Even if all banks become the members of a Central Bank, still there are certain limits to its credit-controlling capacity.

The ultimate use of bank credit is beyond the control of a Central Bank. The Central Bank cannot dictate to commercial banks how the Central Bank credit should be used by them, as the matter is left to their discretion. The Central Bank credit may be employed by a borrowing bank for financing the stock of produce brokers, and these funds may ultimately percolate to non-borrowing banks for employment in speculative loans. Nor can the commercial banks control the purpose for which their credit should be used by the customers. All these factors are beyond the pale of central banking control. So the Central Bank should try to achieve what is humanly possible. Any attempt on its part to overdo its job may precipitate a disaster.

Central Banks and Business Cycles

It is held that in most cases banking operations reflect the results of cyclical fluctuations in business activity and are not themselves the causes thereof, though at times they may appear to be contributory factors. Banks ordinarily do not take the initiative in business finance. In times of boom the customers apply for loans, advances and overdrafts to the banks for expansion of their business activities and the banks do meet those demands for finance on the merits of each proposal. Moreover, bank credit itself emerges partly from the liquid resources of business concerns, which appear in bank deposits.

Just after a boom there is the likelihood of a serious credit-strain developing. The signs of over-production may appear due to the discrepancy between saving and investment. In a period of expanding activity and rising prices forward buying may take place on a large scale in anticipation of still higher prices and in expectation of higher profits. As a result, a maladjustment may ensue from a disparity between production and consumption. In such cases how can a Central Bank control the situation? Bank credit cannot alone control the business cycle, since its velocity is so changeable according to the influence of some non-monetary factors that their effects cannot be neutralised by monetary

action. The Macmillian Committee ascribed these economic difficulties to 'unusually large and rapid changes on the part of what are rightly described as non-monetary phenomena, these non-monetary factors again themselves producing monetary changes'. So it is difficult for a Central Bank to check the business cycle fully. But in spite of some handicaps, it may succeed in its attempt at control by the timeliness of action as to what to do and how far to go. For this purpose, there should be a closer co-operation between the Central Bank and commercial banks which can see at close range what kinds of money are being placed to the credit of customers, how that money is being distributed and what changes are taking place in the total and thus can help the Central Bank with these material data and information to apply quantitative control of bank credit.

In addition to co-operation between the Central Bank and the commercial banks, there should be a closer co-ordination between the Central Bank and the capital market in order to prevent the evils of over-investment as well as of under-investment. For according to Lord Keynes, 'the sustained enjoyment of prosperity requires as its condition that as near as possible the right proportion of national resources, neither too much nor too little, should be devoted to active investment'.

Besides these, there should be a closer relationship between the Central Bank and the Treasury in the matter of framing the correct monetary policy of a country, as the Government is assuming wide powers for the control and regulation of the economic activities. The public works policy constitutes an important plank in the Governmental programme of mitigating business cycles. By retarding investments in times of active trade and speeding up investments in times of declining trade, public bodies can help to restore an equilibrium between saving and investment. The Federal Reserve Board of the U.S.A. observe that the 'Government must be looked upon as a compensatory agency in this economy to do just the opposite to what private business and individuals do.' The Board of the Commonwealth Bank of Australia was of opinion that expenditure on public works should be relatively low in times of prosperity and that plans should be ready for expansion in times of depression. The Central Bank can help the Treasury a great deal in pursuing the correct public

works policy. Though non-monetary factors responsible for business-cycles are outside the radius of Central Banks, there should be a combination of public works planning and credit control by the Central Bank to achieve jointly whatever is possible in this regard. If the money market requires pumping in of additional credit, the Central Bank can create conditions of easy money without an increase in the effective demand for credit, goods and services, and in that case the spending policy of public authorities will help the flow of increasing quantity of money into active use.

Control of Price-Level

The success of a Central Bank in controlling price-level is dependent upon the following factors: *Firstly,* it should be possible to construct indices of prices accurately and promptly. *Secondly,* there must exist a close and consistent relationship between the quantity of money and the price-level. *Thirdly,* a Central Bank is to achieve expansion or contraction of the quantity of money in an exact degree. But in reality such factors are not always existent. The construction of index-numbers is always subject to some limitations. There is no consistent relationship between the quantity of money and the general commodity price-level, as bank credit is one of many other forms of credit required for the purchase of commodities. Cases happen when an increase in bank credit is found to be accompanied by a decline in the commodity price-level. Moreover, the Central Bank, while it observes signs of over-expansion of bank credit, cannot check the tendency by the raising of the Bank rate nor by open-market operations, if the prospects of business are bright for the entrepreneurs, investors and purchasers, and if the commercial banks have surplus cash reserves. The same thing will happen in a period of depression. The Central Banks in different countries could not check the falling price, in spite of the application of central banking weapons, during 1930 and 1934 to offset the demoralising effects of pessimism, distrust, fear of unemployment, etc. So the Federal Reserve Board have rightly opined that it is impossible to combine into any single formula the elements of judgment applicable to varying credit situations as they arise. It is expected that

the technique of credit and price-control will improve in future, but as matters stand at present, price or credit control may be possible in special circumstances and for short periods only.

Recent Central Banking

1. Almost everywhere the tendency is directly perceptible towards the state-ownership of the Central Bank and the assumption of increasing powers by the Central Bank to control credit.
2. Open market operations as a method of credit control have come into active use. The popularity of such operations arises from the decline of the discount rate as an instrument of credit control, the growing rigidity of the economic structure, suspension of the gold standard and the adoption of the managed currency and growing need for state finance.
3. The Central Bank now-a-days avoids direct dealings with the public. This restriction of direct dealings with the public is governed by the following considerations:
   (a) A Central Bank is to maintain a highly liquid position in normal times and is to keep ready for averting any emergency.
   (b) If it deals ordinarily with the public as the commercial banks do, its liquidity may be affected and as a Central Bank, it cannot properly expect to discharge its responsibilities as a lender of last resort and come to the help of the commercial banks in times of emergency.
   (c) Direct dealings with the public by a Central Bank will involve the responsibility of satisfying the legitimate credit requirements of these customers and when any contraction of credit is to be rigidly enforced, the Central Bank, in such a dual capacity, cannot fulfil this function by disobliging its customers.
   (d) Direct dealings with the public will drag the Central Bank into competition with commercial banks. The commercial banks may then, with justification,

resent keeping statutory deposits with the Central Bank, which will be applied against them in competition for business.

(*e*) For stabilising the credit structure, the Central Bank is to count much upon the good will and the co-operation of the commercial banks, which it cannot afford to gain by open competition with them.

4. There is a trend towards the centralisation of cash reserves on the following grounds:

(*a*) When bank reserves are centralised in the Central Bank, they may be fully used in times of seasonal strain and emergency.

(*b*) Supplemented by the rediscounting facilities, the centralisation of cash reserves promotes economy in their use.

(*c*) Statutory centralisation places at the disposal of the Central Banks a certain measure of control over funds with which they can operate and also over credit.

Post-war trend in Central Banking

5. According to the traditional view of central banking, a Central Bank is a lender of last resort. Even as a lender of last resort, it was very stringent about the eligibility for its help. But during and after the war, there has been a striking departure from the traditional policy of central banking and the tendency is definitely towards the relaxation of the 'eligibility' clause and endowing the Central Bank with numerous other obligations. Paper, which was before looked down upon as lacking in security and liquidity, has since been declared eligible by the Central Bank and new types of securities are now accepted by it as collateral for advances. Even the Central Bank in most countries has been authorised to grant industrial credit, which was so long a 'forbidden fruit' for a Central Bank. In the U.S.A. the new regulations as to discounts and advances declared finance paper, construction loan notes and consumers' paper as

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Post-war trend in Central Banking

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If the rediscounting of bills becomes an occasional practice as in undeveloped money markets, the market rates may be out of touch with the Bank rate and the absence of rediscounting may result in the Central Bank remaining out of touch with the money market. But it may at the same time be emphasised that the growth of rediscounting habits is not restricted by the undeveloped nature of the money market. It is quite possible that the undeveloped countries may undergo a rapid and extensive development in the near future when there may be an increased demand for bank advances with the result that banks may be forced to rely upon Central Bank credit in an increasing degree. The Bank rate may then attain a prominent place in these money markets. "There are however certain characteristics which may tend to make the Bank rate a less effective instrument of control in these money markets than in the industrially advanced countries. Many of the countries which have undeveloped money markets are also dependent economies, and their position is in some respects quite different from what may be called dominant economies. In the latter the pace of activities is set mainly by domestic factors, *i.e.*, a burst of investment activities at home, though these may be reinforced by the position of the balance of payments. As the pace of activities quickens under the impact of internal facotrs and the demand for bank advances rises, banks may not be in a position to meet this demand unless their cash balances increase at the same time. There is nothing in the rise of investment activities at home to cause an increase in their cash reserves. They may get hold of additional cash balances in two ways, *viz.*, by selling a portion of their security holdings in the market, and by rediscounting bills, or borrowing from the Central Bank. A rise in the Bank rate will cause difficulties in both these directions. The banking system may therefore be influenced by the Central Bank action through changes in the Bank rate. In a dependent economy, however, the pace of activities is usually set by the state of foreign trade especially by the level of export prices. So the same factors which give rise to increased demand for bank advances also cause an increase in the foreign balances of the banks. The latter may easily replenish their local cash balances by selling these foreign funds to the Central Bank. In so far as the Central Bank aims at keeping the rate of exchange

steady, it will have to supply the banks with cash balances. Banks may therefore be enabled to avoid borrowing from the central bank and escape the restrictive effects of a change in the Bank rate in the upward directions." (Dr. S. N. Sen)

Another factor is that these dependent economies are not international banking centres. They may attract to some extent capital but they have not succeeded in becoming the holders of large amounts of short-term balances from other countries. The amount of foreign funds which they can import is determined by the position of their balance of trade. These countries, being mostly debtor countries, cannot expect any temporary relief by raising the Bank rate when faced with an adverse balance of payments.

The ideal conditions for the success of open market operations are three, namely, the existence of a broad and active security market or a bill market, the maintenance of fixed cash reserve ratios by banks and the absence of rediscounting or borrowing from the Central Bank. The first two factors are absent in these markets. There is only one favourable factor that banks have not yet got into the habit of rediscounting with or borrowing freely from the Central Bank. In spite of these difficulties, open market operations have been successfully carried out by the Central Bank even in the undeveloped money markets. Such operations have succeeded in forcing a policy of caution on the banks in two ways, *viz.*, by depleting their already meagre cash reserves and by making it risky for them to realise their investments in a falling market. The Reserve Bank of India has successfully carried on these operations and the Commonwealth Bank of Australia has also adopted the same policy of giving "judicious support" to the Government securities market. The Commonwealth Bank has succeeded in cushioning the effects of movements in the volume of overseas assets upon the volume of money in the country through sales and purchases of securities. Similarly, the Reserve Bank of India has also succeeded in this direction. It is quite clear that in these countries, movements in overseas assets and in the balance of payments, which formerly affected the volume of currency and bank deposits, no longer exercise the same influence and their impact has been neutralised by open-market operations. In Australia when international reserves con-

to co-operate with one another to tackle the monetary problems on an agreed basis. This co-operative spirit amongst Central Banks has found expression in the formation of the International Monetary Fund and International Bank for Reconstruction and Development.

Problems of Central Banking in Undeveloped Money Markets

The existence of undeveloped money markets complicates the task of a Central Bank due to a variety of factors. One is the absence of a call-loan market which leads to the result that banks do not get into the habit of keeping a fixed ratio between their cash reserves and deposits. As in such cases there occur considerable fluctuations in the reserve ratios of banks, the Central Bank is required to undertake open market operations on a large scale in order to influence the policy of the banks. But such large-scale sales or purchases of securities may not be possible in undeveloped money markets. The absence of a bill market is another handicap of no less magnitude. As has been observed before, a bill market helps the Central Bank by providing short-dated instruments for the investment of its funds and thus enables it to exert pressure on the money market through the process of withdrawal of funds as the bills mature. In the absence of such a market the Central Bank finds difficulties in taking off funds from the market.

The extent of integration between the different sub-markets is comparatively small in these markets. These sub-markets cannot therefore be controlled by the Central Bank through operations designed to influence the banks. For example, in India the money market consists of two parts, *viz.*, the money market as dominated by the banking system and the bazar composed of shroffs, indigenous bankers and others. As these two parts have not been properly integrated, the influence of the Reserve Bank is more or less confined to the first market. If banks habitually rediscount with or borrow from the Central Bank in developed money markets, a higher or lower bank rate is likely to be followed by similar changes in the rates charged by them.

control. The South African Reserve Bank decided to undertake this type of business earlier and to discount sound trade bills to make its bank rate influence the finance of the country and also declared its willingness to accept deposits from respectable parties. Such commercial banking has been recommended in certain quarters to be undertaken by a Central Bank to the extent necessary for establishing regular, daily contact with the money market, and for influencing money rates and the financial policies of the banks. Under the scheme envisaging the creation of a bill market, the Reserve Bank of India has also made such advances to some scheduled banks against usance bills and/or time promissory notes of the latter's constituents. This scheme, if successful, will enable the Reserve Bank to be in constant touch with the money market.

There is a large section of opinion in many countries which supports the principle of the positive control of bank credit by the Central Bank. The Central Bank in the new countries should undertake the task of controlling or even influencing the flow of capital and credit into particular industries. "The tendency for the lop-sided distribution of credit is to be found in the less developed economies. One important characteristic of most of these countries is their reliance upon the production of a few commodities for export. This may induce the business men to concentrate their activities on the already known lines of production and so neglect the development of new industries. Moreover, these countries seem to be determined to crowd into the compass of 5 to 10 years the developments that took 50 or more years in the older countries. The authorities should naturally like to retain in their hands control over the misuse or misdirection of the limited resources."

In an undeveloped economy the Central Bank should have powers to regulate and control the activities of commercial banks. In the undeveloped countries and indeed in the industrially developed countries as well, the functions of Central Banks have not ended with the achievement of control over the commercial banks. They ha[illegible] assume some more responsibility for encour[illegible] [illegible]aking the financing of the development [illegible] country. "This has involved not only [illegible] [illegible] influence of Central Banks

siderably increased during the post-war period, the Commonwealth Bank neutralised the effects of such a large inflow of funds by calling upon trading banks to deposit their surplus funds in *Special Accounts with the Bank.* The technique of influencing the economic system through appropriate variations in the long-term rates of interest is yet to be developed. In order to popularise Government securities amongst the investing public by augmenting the liquidity of the security market, some Central Banks in undeveloped money markets have been required to set up a sort of Stabilisation Fund out of their own resources and use this fund to mitigate or moderate sharp fluctuations in the prices of securities. For example, the Central Bank of Argentina created in 1936 an Intervention Fund aggregating 33 million pesos for the purpose of mitigating abrupt oscillations of the market. A similar step was also taken by the Norges Bank in 1938. This Fund may impart liquidity to the security market and make it possible for the Central Bank to undertake open market operations on a larger scale than before. Some Central Banks are authorised to issue their own securities in the market "at a time when the bank's portfolio of such government securities is small, or if its holdings do not have the maturities or other characteristics desired by the market". The Central Bank of Argentina adopted in 1936-37 the practice of issuing certificates of Participation in Long-term Bonds and in gold and foreign exchange to the commercial banks to absorb the surplus funds of the market resulting from the revaluation of gold and the extremely large favourable balance of trade. These techniques do not, however, solve the fundamental problem of a Central Bank arising from the limited capacity of the local security markets, or from the existence of considerable fluctuations in the cash reserve ratios of the commercial banks.

In undeveloped money markets the method of variable reserve ratios may be profitably used to supplement open-market operations. Recourse to this method does not involve any loss of earning assets on the part of the Central Bank adopting as well open market operations. It has the virtue of keeping undisturbed the security market. There is another reason for preferring this method to open market operations in the undeveloped countries. "Some of these countries do not possess a dominant money market

like that of London, but a number of money markets situated in different areas. There is no centralised, sensitive money market keeping in touch with every part of the country. There is usually a lack of integration between the money markets of the cities, and the smaller towns and other areas. Because of the existence of stock markets in the big cities like Bombay or Calcutta, the open market operations of the Central Bank may have to be confined to these markets. The repercussions of a purchase or sale transaction in these markets may take some time to reach the interior places. The restrictive or expansive waves launched from the big cities will reach the interior but with a considerable time-lag and in considerably diminished forces. A raising or lowering of the reserve ratios will immediately affect all parts of the country. To that extent it is likely to prove more effective in the undeveloped markets than open-market operations." In the upward phase of the trade cycle when the foreign demand for their exports is high, and the overseas assets are rising, it becomes necessary to conserve sufficient resources to enable the country to pass the inevitable recession in foreign demand without substantial cuts in incomes and employment. One way to do this would be to raise the reserve ratio at a sufficiently early stage to slow down the pace of credit creation by the banks. Another possible occasion may be the large scale influx of capital into these countries, such as happened in South Africa in 1947 and 1948 containing the possibility of a large expansion of bank credit, when the Central Bank may raise the reserve ratios as a corrective measure. The Australian system of special accounts goes in some respects further than the method of variable reserve ratios. The former system is more effective in establishing the control of the Central Bank over each bank than the latter method. "The method of variable reserve ratios, with the power of fixing different ratios for particular groups of banks on special occasions, will prove effective in achieving all the objects secured by the working of this system."

It has been argued that in an undeveloped economy, a Central Bank should conduct a certain amount of direct business with the money market. A Central Bank should have the authority to enter the market, and to deal with whom it likes. This it shall do, not for profit-earning purposes, but for purposes of credit

control. The South African Reserve Bank decided to undertake this type of business earlier and to discount sound trade bills to make its bank rate influence the finance of the country and also declared its willingness to accept deposits from respectable parties. Such commercial banking has been recommended in certain quarters to be undertaken by a Central Bank to the extent necessary for establishing regular, daily contact with the money market, and for influencing money rates and the financial policies of the banks. Under the scheme envisaging the creation of a bill market, the Reserve Bank of India has also made such advances to some scheduled banks against usance bills and/or time promissory notes of the latter's constituents. This scheme, if successful, will enable the Reserve Bank to be in constant touch with the money market.

There is a large section of opinion in many countries which supports the principle of the positive control of bank credit by the Central Bank. The Central Bank in the new countries should undertake the task of controlling or even influencing the flow of capital and credit into particular industries. "The tendency for the lop-sided distribution of credit is to be found in the less developed economies. One important characteristic of most of these countries is their reliance upon the production of a few commodities for export. This may induce the business men to concentrate their activities on the already known lines of production and so neglect the development of new industries. Moreover, these countries seem to be determined to crowd into the compass of 5 to 10 years the developments that took 50 or more years in the older countries. The authorities should naturally like to retain in their hands control over the misuse or misdirection of the limited resources."

In an undeveloped economy the Central Bank should have powers to regulate and control the activities of commercial banks. In the undeveloped countries and indeed in the industrially developed countries as well, the functions of Central Banks have not ended with the achievement of control over the commercial banks. They have been obliged to assume some more responsibility for encouraging and even undertaking the financing of the development of the resources of the country. "This has involved not only attempts to extend the sphere of influence of Central Banks

into the comparatively inaccessible or inadequately organised branches of the short-term market, but even incursions into the domain of long-term finance, which is traditionally regarded as lying outside the proper interests of Central Banks." In Australia the Central Bank has taken a direct part in financing agriculture. The Commonwealth Bank grants loans to the primary producers on overdraft terms in its Central Banking Division and has also been required to set up a separate Rural Credit Department for this purpose. The latter is an agency for the grant of loans on special terms to co-operative associations and marketing bodies. The Bank also maintains the Industrial Finance Department and dispenses industrial credit. India and South Africa have followed the British example of establishing separate institutions with the participation of the Central Bank, commercial banks and other financial organisations. Neither the Industrial Finance Corporation of India nor the National Finance Corporation of South Africa is a subsidiary of the Central Bank.

Note-Issue

There are two schools of thought about the principles of note-issue. One school represents the currency principle and the other the banking principle. The exponents of the currency principle hold note-issue as an economical substitute for coins and in order to ensure convertibility of these notes, enjoin cent per cent backing of gold. They recommend that note-issue should be restricted to the amount of gold held by the Issuing Authority and that the volume of note-issue will expand or contract according to the inflow and outflow of gold into and from the country. In any case they hold that note-issue should not exceed the quantity of gold lying with the Issue Department. This will act as a check upon the propensity on the part of the Issuing Authority to permit over-issue of notes, which may ultimately lead to loss of confidence in the currency. But the chief defect of this school is that under this principle the currency system lacks elasticity, which is so indispensable a factor for meeting the exigencies of altered circumstances in the money market.

The exponents of the banking principle hold that, instead of keeping cent per cent metallic reserves against note-issue, it will

be expedient to keep a certain proportion of the outstanding note-issue covered by metallic reserves. This principle is derived by them from their experience in banking which requires only a certain percentage of cash reserves to meet the obligations to the depositors, for the depositors do never withdraw their entire deposits at a time simultaneously with others. On the same principle, the metallic reserves against note-issue are determined. They are of the opinion that by this device the currency system is made flexible and responsive to the demand of trade and commerce. The total monetary circulation can be expanded or contracted according to the needs of trade, which can be best judged by the bankers and financiers.

The solution will lie in a happy combination of the two principles. The currency principle was adopted in the Bank Charter Act of 1844 in England but had to be discarded in favour of the banking principle in course of time. On the whole, the two principles insist on the necessity for the maintenance of adequate reserves against note-issue.

Different systems have so far been evolved to regulate note-issue, namely, (1) Fixed Fiduciary System, (2) Maximum Fiduciary System, (3) Proportional Reserve System, and (4) Foreign Exchange Reserve System. Let us examine the relative merits and demerits of each system.

Fixed Fiduciary System.—Under this system the Central Bank is permitted to issue notes up to a certain fixed limit without the backing of gold reserves. This uncovered limit is called fiduciary, but it is backed by Government debts or securities, though not by gold coins. As soon as the limit is exceeded, it must be backed by 100 per cent reserve in gold. This system has been adopted in Great Britain which permitted note-issue to the limit of £14 million without gold backing under the Bank Charter Act of 1844. It was subsequently raised to £260 million in 1928 and later on to £300 million in 1939 and to £1250 million in 1944 to meet the currency demand of changing circumstances. The idea is to impart through this system an elasticity to the currency structure of the country. But that elasticity is partial and cannot go far. After that limit the elasticity exhausts itself and the currency becomes inelastic in the sense that beyond the fixed limit it cannot expand in response to trade requirements but is subordinated to

the consideration of increased gold reserves. Besides this, in times of emergency the law regarding the fixed limit may have to be suspended. As for example, in times of war the Act is to be suspended to provide for the issue of notes beyond the limit to meet the mounting war-expenditures. Moreover, this system entails an unnecessary locking up of gold as cover. The Macmillan Committee pleaded for the abolition of this system because of the above defects.

Maximum Fiduciary System.—This system fixes the maximum limit up to which the Central Bank can issue notes without any metallic reserve and that maximum limit is subject to alteration according as circumstances demand. This system was in vogue in France before 1928 and was strongly recommended by the Macmillan Committee for adoption in Great Britain. The Australian Banking Commission (1937) made the same recommendation. It will leave to the Central Bank the discretion of determining the limit, in the light of the monetary requirements of the country, without being bound by the statutory provision of legal reserves. Lord Keynes subscribes to this view in his Treatise on Money and recommends the delegation of such discretion to the Central Bank of the country, which is better able than others to put its finger on the pulse of the finance of the country.

Proportional Reserve System.—Under this system the Central Bank is to maintain a certain percentage, generally varying from 25% to 40% of gold reserves. This system was adopted in France after 1928 and was recommended for adoption in India by the Hilton Young Commission. Later on this recommendation was accepted by the Government of India and incorporated in the Reserve Bank of India Act. Under this system if the ratio of gold reserve to note issue is fixed at one to three, then three notes can be issued against one gold coin. Similarly when one gold coin is withdrawn, three notes will have to be cancelled, whereas in the other system one note has to be cancelled. This involves an excessive contraction of currency and is likely to set in motion the deflationary forces, which might prove detrimental to the country's financial position. Sometimes this system leads to a perplexing situation in which the gold reserves, even when held, cannot be availed of for conversion of notes. Suppose that one-third of the note-issue is to be held in gold reserves as a

statutory obligation and the Bank is maintaining just the minimum reserve, one note is presented for conversion. In such a case one gold coin cannot be exchanged as the reserve will then fall below the statutory limit. The system is similar to the regulation that there must always be one cab at the station so that passengers could always be sure of getting one. Suppose there is only one cab and a passenger alights. The cab cannot leave the stand and the passenger's position would be the same as if there were no cab at all.

Foreign Exchange Reserve System.—The Central Bank is authorised in some countries to hold part of its reserve in foreign exchange, including foreign currency, deposits in foreign banks and bills. In our country the Reserve Bank of India can maintain part of its reserves in sterling bills, which means an economy of gold. In Germany which made a combination of the 3rd and 4th systems in Reichs Bank could allow the reserves to fall below the legal ratios provided a tax on the deficit was paid.

The Right Principle of Regulation

One of the striking features in recent central banking legislation is the reduction of the legal reserve ratio with a view to providing greater elasticity in the employment of primary reserves. During the decade 1922-32 there was a noticeable tendency towards the raising of the legal reserve ratio of the Central Banks up to 40% or even more. But such an increased reserve requirement was not without its disadvantages. In order to maintain a large cover-reserve the Central Bank had to employ most of its resources with the result that sometimes it became unable to provide an adequate reserve of international currency. The cover requirement is intended to support national currency and to stabilise internal credit, while the international currency function was needed to meet the discrepancies in the international balance of payments. It does not necessarily follow that with the increase in the legal reserves against note-issue, the credit of the Central Bank will be correspondingly strengthened, for the public in general are indifferent to the question of the cover of bank-notes. Gradually opinion has crystallised in favour of a substantial reduction in statutory reserves with the idea of releasing for other

more productive purposes the metallic reserves, which would otherwise have remained blocked. The plea for such reduction was also raised by the Gold Delegation Committee, and the Monetary and Economic Conference, which was held in London in 1933, recommended the reduction to 25% level. Since 1933 the tendency has revived towards lowering the legal ratio. The Bank of Canada adopted a minimum statutory reserve ratio of only 25%, the National Bank of Denmark 25%, the National Bank of Copenhagen 30% as the minimum cover.

With the outbreak of the war in 1939 the Governments of the respective warring nations were faced with the problems of meeting soaring war-expenditures and of releasing gold and exchange reserves for meeting foreign payments without causing any internal contraction of currency. Accordingly, in many countries legal reserve ratios were relaxed or abolished. As for example, in Germany, Italy and Greece they were abolished before the war and in Canada they were suspended in 1940. In England the fiduciary limit of £300 million was raised even up to £1250 million in December, 1944, which shows that the fiduciary limit may be exceeded whenever necessary. In Belgium, again, the reserve requirements had to be suspended in 1944 for utilisation of the gold-stocks for reconstruction purposes. In the U.S.A., the reserve requirements of the Federal Reserve Banks were reduced to a uniform level of 25% in gold certificates against Federal Reserve Notes in circulation and deposit liabilities by an Act of Congress, June, 1945. The recent move is, therefore, initiated towards the adjustment of cover requirements to the increased note circulation, instead of circulation being adapted to the legal requirements.

The right course should be to lay down that the amount of metallic reserves should bear no relation to the volume of note-issue. But to impose a check on the propensity to cover issue of notes, it is at the same time desirable to fix the maximum limit of the issue, which should be well above the average amount of note-circulation and subject to revision from time to time. Moreover, in order to create public confidence, it should be necessary to decree that the bank should hold the minimum metallic reserves required for the purpose. It is now being increasingly recognised that the credit of a Central Bank depends not so much

on its 'Cover' reserve as on its international 'Currency' reserve, which should be built up with all possible care and economy of internal reserves, to adjust the discrepancy in the balance of payments. The determination of these reserves should be left to the discretion of the Central Bank.

INTER-RELATIONS OF CENTRAL BANKS

An individual bank is compelled—unless it is prepared to allow its reserve ratio to be modified (up or down)—to keep step with the other banks of the system including the Central Bank. They can all march forward together and they can all march backward together. But a single bank cannot move unless the others move too ; for otherwise its loss or gain of reserve resources will rupture its reserve ratio. The discretion of the Central Banks in respect of their lending policies is conditioned by the effect of these policies under reserve, whether these policies are causing them to draw reserve resources from or to lose reserve resources to their neighbour Central Banks ; and there is a similar pressure on them to keep step unless they are prepared to see their reserve ratios modified.

The reserve ratios of the Central Banks are not so rigid as we have found them to be in the case of member banks. In the first place the Central Bank has not, generally speaking, a resort open to it for the rapid replenishment of its reserves corresponding to the member banks' facility for discounting directly or indirectly with the Central Bank. To the extent that Central Banks maintain balances abroad or interest-bearing assets other than gold, which are of such a character that they can be quickly sold to other Central Banks, the analogy between the position of a Central Bank and that of a member bank is somewhat closer. In the second place, the Central Bank is not aiming at a maximum profit as we have assumed that a member bank is. Thus all accounts of considerations of public policy of national advantage may influence it to keep a reserve in excess of the minimum required by law and even in excess of that required by reasonable prudence. It follows, therefore, that the reserve ratios of the Central Banks are capable of wide fluctuations.

Between Central Banks there is a form of competition.

Changes in the relative bank rates of different national systems may affect the flow of an important fringe of international financial business from one place to another according to the rates obtainable. Here is a floating body of claims on international reserve resources which any individual Central Bank is able to bid for when it is suffering an excessive loss of its own reserves.

Over short periods a Central Bank has a greater discretion for the amount of bank money which it creates than a member bank has: *firstly,* because it is more willing to vary its reserve ratio ; *secondly,* because in some cases more of its creations come back to itself and go on doing so for a long period ; and *thirdly,* because the offer of competitive rates of interest wherewith to divert financial business as between itself and other Central Banks is available to it as a regular and open expedient for the protection of its reserve resources. Since, however, the latitude of a Central Bank is limited in each of these directions, there are three things which it has to watch if it is to be sure of being always able to meet claims maturing against it in the hands of the foreign monetary system, namely, (1) its reserve ratio, (2) the effect of its lending policy on the balance of trade on income account, (3) the effect of its lending policy on the movements both on long-term and short-term international loans. In an international system a Central Bank can pursue this policy within narrow limits and for short period ; where larger changes and longer periods are concerned its policy is necessarily governed by the policies of all the other Central Banks. But apart from small movements and short periods its Central Bank is necessarily governed by the average policy of the Central Banks as a whole. An international system works particularly badly if the Central Banks which are strong enough to dominate for a time the general tempo and to set the pace for the others use their power to promote national policies which are out of keeping with the requirements of the international position as a whole.

International Monetary Fund and International Bank for Reconstruction and Development

The International Monetary Fund commenced its operations from 1st March, 1947. The Fund is vitally interested in the

blems of international payments. It lays down certain standard of behaviour to which the members of the Fund will have to conform for the purpose of the promotion of exchange stability, the maintenance of orderly exchange arrangement and the avoidance of competitive exchange depreciation. It was intended primarily for the correction of the fundamental disequilibrium in the balance of interest payments and for the attainment of a high level of international trade and investment on a multilateral basis. It was one of the diverse instrumentalities for the achievement of international co-operation on matters of monetary problems on an agreed basis. The Fund's objectives can be attained only when the productive capacity of the war-devastated countries is restored to a point where equilibrium in its balance-of-payments position is established.

After the end of the war the world is faced with the stupendous problem of reconstruction. Production has marked a significant fall in almost all the countries. In Europe and the Far East the flow of production is interrupted by lack of raw materials and the necessity for replacement of old equipment. The world trade has undergone a radical change. Exports from all countries, with the exceptions of Canada and U.S.A., have fallen off. But in the U.S.A. and Canada exports were 40% larger in volume than before the war. The income derived from invisible exports has shrunken to a low level in the U.K., partly because of the liquidation of external resources and the destruction of direct investment during the war. On the whole there has been a serious disturbance in the balance-of-payments position of the world.

Grants by Governments to meet relief and rehabilitation needs from the end of the war to the middle of 1947 amounted to about $7.7 billion excluding civilian supplies to Germany. Of these U.S.A. contributed 74%, U.K. 17% and Canada 4%. Large Governmental credits have been made available to finance reconstruction to the extent of $13 billion. These credits were exhausted quickly in view of higher prices and greater dependence on imports of food and coal etc. The monetary reserves of the rest of the world were gradually depleted for meeting the continuous deficit in the balance of payments with the U.S.A. It is not physically possible for the International Fund to meet the financial require-

ments of post-war reconstruction, the magnitude of which appears to be far greater than was foreseen in 1945 and 1946, unless other Governments extend additional aid. It will be unfortunate if the existing flow of aid remains immobilised due to lack of goods, essential for the promotion of productive capacity. The member quotas in the Fund have since been increased by 50%.

To supplement the work of the Fund, the International Bank for Reconstruction and Development was constituted for the following purposes:

1. To assist in the reconstruction and development of territories of members by facilitating the investment of capital for productive purposes, including the restoration of economies destroyed or disrupted by war, the reconversion of productive facilities to peace-time needs and the encouragement of the development of productive facilities and resources in less developed countries.
2. To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors; and when private capital is not available on reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own capital, funds raised by it and its other resources.
3. To promote the long-range balanced growth of international trade and the maintenance of equilibrium in balances of payments by encouraging international investment for the development of the productive resources of members, thereby assisting in raising productivity, the standard of living and conditions of labour in their territories.
4. To arrange the loans made or guaranteed by it in relation to international loans through other channels so that the more useful and urgent projects, large and small alike, will be dealt with first.
5. To conduct its operations with due regard to the effect of international investment on business conditions in the territories of members and, in the immediate post-war years, to assist in bringing about a smooth transition from a war-time to a peace-time economy.

Capital.—The Authorised Capital of the banks is $ 10,000,000,000 in terms of U.S. dollars of the weight and fineness in effect on July 1, 1944.

20% of the capital shall be called up for the time being and the remaining 80% in times of necessity. Payment of subscriptions for shares shall be made in gold or U.S. dollars and in the currencies of members up to certain limits. Shares shall not be pledged or encumbered in any manner whatever and they shall be transferable only to the Bank.

The Bank's subscribed capital has increased from $7670 million to $8224·5 million.

The capital to be paid up is to amount to 20% of the Bank's subscribed capital. The remaining 80% is subject to call when needed. The Bank has obtained permission from the U.S.A. and Belgium to use for lending purposes its paid-up capital.

The Bank's guarantees, participations in loans or direct loans must not exceed 100% of the unimpaired subscribed capital, reserves and surplus of the Bank.

Constitution.—The Bank will be managed by a Board of Governors consisting of one Governor and one alternate appointed for 5 years by each member. The Board shall select one of the Governors as Chairman. The Board may delegate to Executive Directors certain powers with some exceptions. The Board shall determine the remuneration to be paid to Executive Directors and the salary of the President.

The Executive Directors' number will be 12, of whom 5 will be appointed by each of the five members holding the largest number of shares and the remaining 7 by the rest of the members. The Executive Directors shall be appointed or elected every two years. The Executive Directors shall be responsible for the conduct of the general operations of the Bank. The Executive Directors need not usually be Governors.

The Executive Directors shall select a *President* who shall not be a Governor or an Executive Director. The President will be the Chairman of the Executive Directors.

The Bank possesses certain immunities from taxation, seizure of its assets, and privilege of communications and freedom of assets from restrictions.

The members of the International Monetary Fund shall be the

members of the Bank as well. Any member may withdraw at any time by giving a notice to the Bank.

Operations of the Bank

Acceptance of Risk.—Since one of the primary purposes of the Bank is the revival of private foreign investment, it is obvious that the Bank must not refrain from making loans simply by reason of the general economic and political uncertainties which at present obstruct the free flow of private capital ; indeed one essential objective of the Bank's loans is to help to remove these general uncertainties and to establish conditions in which private capital will be once more able to play its part. Nevertheless, the Bank cannot make imprudent loans.

The Bank shall use funds in a way which will result in the greatest possible increase in productivity in the shortest possible time.

The Bank will undertake limited commitments. When a loan has been made, the proceeds are made available to the borrower only against evidence that the goods or services to be paid for with those proceeds are within the purposes of the loan.

The investigation of the Bank into the loan-application will not only cover the programme or project for which the funds are sought, but all important aspects as well of the borrower's economic position. In so far as the prospects of the soundness of any loan are affected by condition of political instability or uncertainty in the borrowing country, those political conditions must be taken into consideration.

The Bank's function is to provide a catalyst by which production may be gradually stimulated and private investment encouraged. Its funds must be used for financing programmes or projects which will eliminate bottlenecks to production, stimulate revival or development of industry and agriculture, rehabilitation and reconstruction of the entire economies. Or in other words, the funds of the Bank should be invested prudently from the standpoint of the investors and wisely from the standpoint of the world. It must help to raise the level of the world's production, no matter whether it results from a development or reconstruction project.

In the first instance, the Bank lays emphasis upon the problems of European recovery, where productive capacity and skills already exist and they may be put to work if new machinery and replacement of equipment are furnished. The recovery of Europe is designed to promote the expansion of economies of other regions. Though appreciable progress has been achieved in the restoration of the productive economies still Europe is faced with serious bottlenecks like shortage of food, fuel, and manpower. Less undeveloped regions must fulfil the following conditions before they are eligible for loans from the Bank:

1. They must improve their credit position by clearing up their external debt records.
2. They must introduce a sound budgetary system and a sound monetary system which are necessary for maximising production.
3. Flow of capital (private) must not be subjected to inequitable and restrictive legislation.

The Bank can solve in part the stupendous problem of reconstruction. There must be continued assistance from other sources like Marshall Plan.

Loans for electric power development were made to Brazil, Columbia, Iceland, South Africa and Uruguay ; for the expansion of transportation facilities to Australia, Columbia, Ithiopia, Nicaragua, South Africa, Thailand and Turkey ; for flood control and irrigation to Iraq and Thailand ; and for agricultural machinery and grain storage to Nicaragua and Turkey. The Bank has continued its use of the comprehensive survey mission as a means of drawing up broad recommendations for a country's economic development.

In May, 1951 the Bank sold £5 million of its own bonds in the London Investment Market, and thus for the first time added to its lendable resources of pounds sterling by tapping private investment funds. In January, 1951 when the Bank made a loan to the Union of South Africa for the development of transportation facilities eight American commercial banks simultaneously extended to the Union Government a credit of $10 million for purposes related to the Bank's loan. The two loans were, in effect, one credit transaction in which the Bank and private investors cooperated. India has also got several loans from the Bank to

finance the expansion of steel production, shipping, river valley project, etc.

The need for care in the planning of economic development exists at all times—regardless of economic trends and shifts in economic relationships among nations. The main instrument of all development is accelerated capital formation. The Bank has always emphasized that economic development is a continuous process, and that its success depends to a large extent on the ability of the countries themselves to mobilize their total resources successfully and to use them to the best advantage. It may be stressed that many advantages are to be gained by under-developed countries if they begin the admittedly difficult task of formulating their long-run developmental aims with an unbiased appraisal of the relative urgency and the technical feasibility of the various parts of their programmes. It is equally important for them to base their plans on sound monetary and fiscal policies. Objective and careful planning can greatly accelerate the speed of economic development. Moreover, the full utilization of a country's ability to make effective use of its own resources will contribute substantially to its ability to service foreign loans.

Except for the early reconstruction loans, the Bank's lending operations have been concentrated in the field of basic utilities. An adequate supply of power, communications and transportation facilities is a pre-condition for the most productive application of private savings in new enterprises. It is also the first step in the gradual industrialisation and diversification of the under-developed countries. Special categories of loans are those made to existing newly established credit institutions to provide them with foreign exchange resources which they in turn can put at the disposal of private borrowers engaged in small or medium-sized business. The Bank's purpose in making this type of loan is to encourage private initiative in activities which can do much to increase production and improve living standards.

The speed of development will depend upon the effectiveness with which economic resources throughout the world are allocated and used ; upon the skill with which development programmes are designed ; upon competence in administration of specific projects and of policies affecting development ; upon the success with

which developing countries mobilize domestic capital ; and upon the determination of both the advanced nations and the under-developed nations to give economic development its proper emphasis.

The Bank made total loans of $ 703 million during the year ended the 30th June 1959. Member countries have been invited to double their capital subscriptions. The authorized capital of the Bank has been recommended to be increased from $ 10 billion to $ 21 billion. The membership of the Bank has increased to 68. Half the year's new loans at $ 354 million were made in Asia and the balance was made up of $ 136·5 million in Latin America, $110·6 million in Africa and $ 102 million in Europe. The pattern of lending laid emphasis on the strengthening of basic services. Development of electrical power received the utmost attention. Transportation came next and the bulk was lent for railway improvements including $ 85 million for the Indian Railways. Loans for industry aggregated $ 149 million, largely for steel, paper and mining. The Japanese steel industry benefited largely from these loans. The Finnish chemical pulp industry and Italian chemical industry also were granted loans.

The high rate of Bank lending necessitated new borrowings totalling $ 432 million. One new bond was sold in the U.S.A. and three-quarters of the total were borrowed from investors in other countries like West Germany, Belgium, Switzerland, etc.

The Bank has also been providing technical assistance and liaison to several member countries. It is also running the Economic Development Institute for the training of staff.

For several years the Bank has been paying greater attention to the needs of under-developed countries. Power loans to the tune of $ 25 million were sanctioned to India in 1958 to be re-lent by the Government of India to the Damodar Valley Corporation while another loan of $ 25 million was proposed to be re-lent to the Bombay State Government for the purpose of constructing the Koyna hydroelectric power plant.

Criticism of the Bank

The Bank has often been criticised for its bias in favour of the borrowers *vis-a-vis* creditors, as the International Monetary Fund

came in for much criticism for its pro-creditor and anti-debtor bias. It is said that the Bank will be at the mercy of the borrowers who will virtually be controlling its funds.

Another criticism that has been levelled against the Bank is that as the U.S.A., the only creditor country of the world, has a predominant voice in its affairs, it cannot be called an international institution in the true sense of the term.

It has been contended that the Bank will oust private foreign lending altogether. But such a contention is not true, as the purpose of the Bank is to encourage private foreign investment and not to supplant it.

It is widely held that the Bank has been started to rehabilitate the economies of European countries only and it has no intention to promote the cause of the undeveloped Asiatic countries. The Bank is to remove this apprehension by ready assistance to Asiatic countries as well. Mr. B. Rama Rau, the ex-Governor of the Reserve Bank of India, in the eleventh annual meeting of the Boards of Governors of the International Monetary Fund and the International Bank for Reconstruction and Development stressed the fact that the countries of Asia are possibly in greater need of urgent economic development than many others. They are engaged in this task to the limit of their resources and have now no shortage of projects which are eligible for financing by the Bank. Asia is, therefore, ripe for a substantial share in the lending operations of the Bank. He further emphasised the need for eliminating the special 1% interest rate.

Professor Triffin's views on international liquidity and the role of the Fund

According to Professor Triffin, the most fundamental deficiency of the present system and the main danger to its future stability lie in the fact that it leaves the satisfactory development of world monetary liquidity primarily dependent upon an admittedly insufficient supply of new gold and an admittedly dangerous and haphazard expansion in the short-term indebtedness of the key countries.

The reserve deficiency for the next decade, over a above

prospective additions to reserves in the form of gold, on the rates of growth of trade, ranges from 3% to 6% a year. The gap between required normal additions to reserves and prospective additions to reserves in the form of gold should not be filled by larger international holdings of dollar or sterling balances or any other national currencies as the growth of these foreign balances weakens the net reserve positions of these countries. The present position is unstable because of the large amounts of dollars and sterling held as reserves.

The use of gold as a major component of international reserves has hardly any economic justification. The use of national currencies economises on the use of gold but this use was "developed haphazardly under the pressure of circumstances than as a rational act of creation". This development gives rise to the risk of run on currencies and of flight to gold.

The world is in need of an international organization to create a new type of reserve, one with an international character to replace all exchange reserves held in national currencies. The members should hold reserves in only two forms, viz., gold and deposits with the I.M.F. and should agree to accept transfers of these deposits in the settlement of their balance of payments accounts. They should keep a certain percentage of their gross reserves in the form of deposits with the I.M.F. Gross reserves are to be defined as gold, net creditor claims previously accumulated on the I.M.F. and other liquid or semi-liquid foreign exchange holdings, *i.e.*, primarily dollar and sterling balances. Members would have to deposit all official holdings of any national currencies that they did not convert into gold. These additional deposits could be used freely to make all international payments. Such deposits with the I.M.F. would be used along with gold and be fully equivalent to it in international payments and should enjoy an exchange guarantee. The I.M.F. should be empowered to create new deposits on the basis of loans or investments in its member countries.

The substance of Professor Triffin's proposal is to make the I.M.F. "a central bank for central banks, with the responsibility and authority to do for central banks internationally what central banks now do for commercial banks nationally".

(Source: I.M.F. Staff Papers, May, 1961, Vol. VIII, No. 2).

The International Finance Corporation

The above Corporation was formed in July 1956 with an autho- ----d capital of $ 100 million. A number of countries which are members of the International Bank for Reconstruction and Development have joined the I.F.C. The Corporation seeks to promote economic development by:

(1) Investing in productive private enterprises in association with private investors and without Government guarantee of repayment in cases where sufficient private capital is not available on reasonable terms ;

(2) serving as a clearing house to bring together investment opportunities, private capital (both foreign and domestic) and experienced management ;

(3) and helping to stimulate the productive investment of private capital, both domestic and foreign.

The Corporation is to operate as an affiliate of the I.B.R.D. up to 1960. It made new investments to the extent of about $ 45 million in 36 countries raising the total to $ 195 million. The Corporation usually invests in soundly conceived and well-managed enterprises ; investments are made on terms which are likely to produce reasonable profits in the event of success. Of the 36 enterprises so far financed, 21 are locally owned, 10 are ventures of joint local and foreign ownership and 5 are subsidiaries of foreign firms.

CHAPTER IV

NATIONALISATION OF BANKING

Central banking has not yet reached a final and settled status. It is passing through a phase of evolution under pressure of world events and international situation. The art of central banking, which was practised before the beginning of the second world war, has undergone a revolutionary change in its concept and technique after the conclusion of the war. The changes have been brought about, *firstly,* by the strain on Government finances imposed by the prosecution of the war ; *secondly,* the urge for liquidity to meet the fluid circumstances ; *thirdly,* the increased need for payment of foreign imports and other expenditures abroad. With the end of the war economic planning and full-employment policy came into limelight, when the status and structure of the Central Bank had to be reviewed against that background. In England, the Labour Government, when installed in power, felt the necessity of abolishing the idea of keeping politics and finance separate and with that idea they took the first step to nationalise the Bank of England, which, to quote the words of Mr. G. D. H. Cole, possessed the tradition of "a great city institution, belonging to the world of high finance rather than to that of Government and proud of its independence *vis-a-vis* the state". It was further recognised that no Government could carry out its monetary policy if the Central Bank of the country stood in the way. And to achieve that objective the Bank of England had to be nationalised.

Apart from the structural changes introduced by the Bank of England Act, no attempt was made to effect any revolutionary change. Rather scrupulous care was taken to keep *unimpaired* the delicate structure of central banking mechanism, which was evolved in England in course of more than two centuries. This is why the present "Court" with reduced number of Directors was retained instead of being replaced by a panel of advisers as in Australia. It was argued in certain quarters that the catalogue

of changes was no changes and the Bank of England in 1946 will not differ significantly from that of 1945. Let us now examine the few changes wrought by the said Act:

1. Before the passing of the Act, the Bank of England retained its separate existence from the Treasury. In the event of a disagreement between the two, the voice of the Government did not always prevail, as was demonstrated in 1931 when the Bank called upon the Government to reduce its unemployment expenditure. Politically the Bank was independent of Parliamentary control. The Labour Government felt that the last word should lie with the Treasury in respect of financial policy and accordingly the change was effected in this respect.
2. So long the credit of the Bank of England was allowed to grow independently of the credit of the British Government, but henceforward 'the credit of the Bank of England will be tied to the *apron-strings* of the British Government'.
3. The next important change, which evoked much criticism, relates to the insertion of Clause 4 Sub-section 3 whereby the Bank of England was empowered to request information and make recommendations to bankers as well as issue directions with the concurrence of the Treasury. (In practice the initiative in making enquiries is left to the Bank of England—not to the Treasury and the Bank would need specific authority to enforce any request or recommendation.) This clause raised a storm of protests, inasmuch as it might be used to infringe the legitimate secrecy of the bank-customer relationship and to exercise powers of control over joint-stock banks in furtherance of the policy of the Labour Government. After much discussion it was decided to add a sub-section that no such request shall be made with respect to the affairs of any particular customer of the bank. Still under this clause, the Bank of England will have authority to direct other banks to apply their resources in particular channels of investments, which, in the opinion of the bank and the Government is necessary 'in the interest of a planned priority with a view to securing full employment and

building up export trade and other necessary elements' of the national economy.

Nationalisation of Central Banks.—From the planned policy of full employment it is desirable that there should be a closer relationship between the Government and the Central Bank than is obtainable if it remains a shareholders' bank. In the present age, the Government is often to undertake deficit spending with a view to promoting full employment. For this purpose the rate of interest should have to be kept stable. The control over the rate of interest is exercised by the Government, not in its capacity as a 'borrower' but in that of a 'controller' of the Central Bank. Besides this, the post-war world is visualising schemes for international co-operation and collaboration on all vital matters affecting the peace and prosperity of the world. As for example, the World Bank and the International Monetary Fund have been set up. As such organisations rest on the consent of the respective Governments, the Central Banks will function as mere agents and instruments of their respective Governments. So the positive co-operation of Central Banks with their Governments in the circumstances may have to be ensured by nationalising them so that they may form an integral part of the public machinery of economic regulations in the field of international as in that of national affairs.

In many countries the Central Bank has been nationalised. The Commonwealth Bank of Australia was brought under public control by the passing of the Commonwealth Bank Act in August, 1945. The Bank of France was similarly nationalised. The Reserve Bank of New Zealand is an outstanding example of a nationalised Central Bank as from April, 1936. The Bank of Canada was established in 1935 as an entirely private shareholders' bank. By the Bank of Canada Amendment Act of June, 1938, the Bank was nationalised. Reference may be made to Denmark's National Bank, which has also been nationalised by the law of 7th April, 1936. On the whole, the trend is towards increased state control and participation in the policy of the Central Bank.

Nationalisation of the Reserve Bank of India.—From the foregoing discussion we have observed a perceptible tendency towards the state-ownership and control of the Central Bank of a country. Banks which were originally founded as private shareholders' banks had to be converted into nationalised institutions

in later years for greater interest. Naturally opinion has now definitely crystallised in favour of nationalising the Reserve Bank of India. The National Planning Commission also opined in favour of state-ownership of the Reserve Bank of India. In the budget-speech of 1947, the then Finance Member announced the policy of the Government to nationalise the Reserve Bank of India. Accordingly the Reserve Bank of India was nationalised on the 1st January, 1949 under the Reserve Bank (Transfer to Public Ownership) Act, 1948.

Nationalisation of Commercial Banking.—By nationalisation of banking is meant the state-ownership of banking in general. Soon after the conclusion of the second world war there has been a perceptible drift from uncontrolled laissez-faire policy to a policy of socialism based on controlled economy. Since banking forms an important sector of economic activities, there is a growing demand for the regulation of the banking trade by the state, which ultimately culminates in a demand for the socialisation of banking. In recent years the Bank of England, the stronghold of century-old individualism, the Bank of France, bred so long in the same school of laissez-faire like England, the Central Bank of Czechoslovakia and the Commonwealth Bank of Australia having been nationalised, the issue about the nationalisation of the Central Bank of a country has been more or less settled. But the demand does not end there, but has gathered momentum for the nationalisation of the commercial banks as well.

Mr. Sayers discusses this problem under the following heads:—(1) Efficiency Issue, (2) Integration Issue, and (3) Monetisation Issue, (4) General Socialisation Issue, and (5) Transition Issue. These heads exhaust the arguments of the protagonists of nationalisation.

Arguments for.—The protagonists of nationalisation hold that nationalised banks will be discharging their functions more efficiently than the joint-stocks under private management. Under private control the banks, the protagonists maintain, 'do not do their work of distributing loanable funds and transferring deposits as efficiently as a public institution would do it'. They opine that banks when nationalised will be functioning with greater economy than under private management.

The Integration Issue turns upon the adequacy of the weapons

which the Central Bank should possess to control banking in general. If the Central Bank is chosen to be nationalised, integration, according to them, implies the nationalisation of the commercial banks. Otherwise nationalisation will not produce the desired results.

The third argument in favour of the bank-nationalisation is this that if the Central Bank of a country has preponderant reasons to be nationalised because of its being the creator of money, which should be the exclusive prerogative of the state, then the joint-stock banks should, for the same reasons, be nationalised as they are also the creators of money.

The fourth argument is that if socialism has come to stay, what objection might there be to nationalise the banks in general, as otherwise the process of transition from capitalist to a socialist form of economic organisation by nationalising the key-industries, might be hampered by the independent policies pursued by these private banks? The supporters say that the 'independent banks might sabotage socialisation by refusing to lend or at least discriminating against industries already socialised'.

On counter (1) to (4) the net advantage in favour of nationalisation is substantial enough to make it worth-while enduring the pains of any financial crisis which the process of nationalisation might precipitate.

Arguments Answered.—Antagonists hold that as soon as the banks pass into the hands of the Government, red-tapism, bureaucracy, routine, proverbial delay in the disposal of urgent matters caused by the requirement of the meticulous observance of technicalities, are bound to arise and as a result, efficiency will suffer. In the ordinary course of business, speed is to be matched with banking services and the banks under private management have so far made a happy combination of speed and efficiency. It is not true that private banks have failed to make a proper distribution of loanable funds or transfer funds as efficiently as Government institutions. Further, it cannot be proved that these banks are exploiting the public by earning unduly high profits or weakening their position by the adoption of expensive and uneconomical methods. One evil, which can be checked more surely by nationalisation, is the tendency of banks under private management to open branches at too many geographical points, as it were

in a spirit of competition with other banks. But this objective can be achieved by increasing control being given to the Central Bank of the country, to check indiscriminate opening of branches, as has been done by the Banking Companies (Restriction of Branches) Act, 1956, since replaced by Section 23 of the Banking Companies Act, 1949, in India instead of nationalising all the banks. Competition between banks is confined to the quantity and quality of service. Mere nationalisation will not settle the choice in this regard.

The argument that independent joint-stocks are not amenable to control by the Central Bank and that for the sake of more effective control those banks should be nationalised is subject to counter-arguments. The Central Bank possesses other weapons whereby centralised control is possible commensurate with much autonomy for the individual banks. The methods of control exercised by the Federal Reserve Banks in the U.S.A. over member-banks are sufficient proofs of the adequacy of control. The scheduled banks in India are gradually coming under the increasing control of the Reserve Bank of India. The authority given to the Reserve Bank of India to inspect any bank is a potent weapon for enforcing control. The Banking Companies Act, 1949, invests the Reserve Bank of India with wide powers. So control may be enforced in an increasingly effective manner even with nationalisation.

As the banks will always prefer to lend against Government securities in consideration of their liquidity and safety, they shall have no objection to lend to socialised industries which will then be as good as state-securities.

Trend in Foreign Countries.—In England though the Central Bank has been nationalised, the joint-stock banks have been still under private ownership and management. But in order to exercise effective control over commercial banking, the Bank of England has been invested with wide powers under clause (4) of the Bank of England Act, to request information from and make recommendations to bankers as well as issue directions, if authorised by the Government provided that no such request or recommendation shall be made with respect to the affairs of any particular customer of the bank. Thus it is expected that the Treasury, the Central Bank and the clearing banks would have to pull well together.

But the French Government did not stop merely by nationalising the Bank of France. On the contrary, the Government proceeded to the extent of nationalising the four deposit banks, namely, Credit Lyonnaise, Societie General Comptoir-d', Escompte and Banque National pour le Commerce et l' Industrie. The shareholders will not be paid all at once but over a period of 50 years. The shareholders will no longer have any say in the management of those banks, which will henceforth be managed by a Board of Directors composed of 12 members to be nominated by the Government after providing for due representation of the following interests:—(1) Industry, commerce, and agriculture ; (2) trade-unions ; (3) the Bank of France and other public credit institutions ; (4) persons with banking experience. As the above four deposit banks command 55% of the country's total deposits, they were first of all nationalised leaving out for the time being the other deposit banks, which may gradually be nationalised. In Czechoslovakia also banking in general has been nationalised.

After weighing the pros and cons of nationalisation, it is problematic to say whether nationalisation of banking as a whole will produce better results. Sayers rightly observes that this is a matter for the politicians, and not the economist, to decide. If the politicians decide upon a general policy of nationalisation, it is argued that banking should be nationalised after the major key-industries are socialised. The problem will then boil down to the choosing of the timing of bank nationalisation and not to the choosing between private and nationalised banks. It is apprehended that bank-nationalisation will lead to the extinction of an independent race of bankers whose advice and services are worth having.

SHOULD INDIAN BANKS BE NATIONALISED?

In India private enterprise and initiative have not yet exhausted their utility. There is enough scope for private initiative in India which is yet to be fully exploited to develop the country economically. In our country there was no individualism in its developed form. The only "ism" that existed in our country until before the 15th August, 1947 was British Imperialism. Naturally under the crippling influence of Imperialism, individualism in its true sense could not gain any foothold in the Indian soil. So that

stage has not been reached in our country when we can say that private enterprise and initiative have outlived their utility and so without any risk, may be totally abolished.' Mr. R. K. Shanmukham Chetty, the ex-Finance Minister observes, 'Today and for many years to come there will be need for public enterprise and private industries'. From this observation it will appear that the necessity for private enterprise is still recognised as a potent influence for unleashing the productive forces, which still lie dormant. Besides this, nationalisation cannot be enforced overnight, for which purpose some preparatory processes are to be undergone. An industry becomes fit for nationalisation when it has attained a developed stage, which may be called the stage of maturity. But in our country banking is admittedly undeveloped and has to travel a wide distance to reach that stage when we can safely say that banking has been fully developed. Before that it will be a premature step to think of nationalisation of banking in general.

Besides the above difficulty, the problem of nationalisation is exceedingly complicated in our country for more than one reason, as our country is so vast and the population so large. As against nine or ten trading banks in Australia, six or seven big banks in France, we have in our country over 730 banking companies, about 100 of which are scheduled banks. Their interests are varied and complicated, and their liquidation, payment of compensation, and other kindred matters involved in a scheme of nationalisation will be too exacting and brain-racking for the Government, which is already preoccupied with major issues requiring immediate solution. There is an acute scarcity of trained personnel who can shoulder the additional burden of the task of bank-nationalisation. So the paucity of trained Government staff is a hindrance to the execution of a policy of bank-nationalisation in the present situation.

Moreover, there is no guarantee that the standard of banking will improve through the magic-spell of nationalisation in comparison with what we find today under private management. The supporters of nationalisation could not advance cogent arguments to show how it could improve the quality of banking. On the contrary, it may be argued that if the Central Bank of the country is given wide powers of control over private banks and banking activities are regulated in conformity with a well-framed Banking

Act, the standard of banking may be raised without the help of nationalisation. In our country informed quarters are of opinion that the stage has not yet been set for bank nationalisation. They would rather recommend the amalgamation of small banking units, with which our country is dotted, to form a few strong banking units, instead of wholesale nationalisation. Amalgamation by way of the merger or absorption of small banking units is more suited than nationalisation to the existing circumstances in India. So in our opinion nationalisation should wait till the country is fully prepared for it. But the Economic Programme Committee appointed by the All India Congress Committee under the chairmanship of Pandit Jawaharlal Nehru, Prime Minister of India, at its meeting on January 22, 1948 and January 26, 1948 recommended that banking and insurance should be nationalised. The latter has, however, been nationalised in 1956.

CHAPTER V

BANKING IN DIFFERENT COUNTRIES

BANK OF ENGLAND

The Bank of England is the oldest Central Bank of the world. In popular terms it is known as the "old lady of Thread Needle Street". It was founded in 1694 by an Act of Parliament and a Royal Charter under the name of the "Governor and Company of the Bank of England". It is the pivot and centre of English banking and holds a unique position in the monetary system of the world.

The Bank was managed by a Court of Directors composed of a Governor, Deputy Governor and 24 other Directors elected by the shareholders. The tenure of the office of the Governor and the Deputy Governor was for a period of two years in each case. The Governor and his Deputy were the Chief Executives of the Bank. The Court meets every Thursday and disposes of important matters like policy-framing, determination of the Bank Rate of Discount etc.

The Bank was granted the monopolistic right of note-issue in 1708. The most important legislation affecting the Bank of England was passed in 1844 whereby the Bank was divided into two Departments, namely, the Issue and Banking Departments. Under the Act, the Bank could issue notes without cover to the maximum limit of £14 million and could increase this fiduciary issue in proportion to two-thirds of the amount withdrawn, should any bank choose not to issue any note. The Bank was to publish a weekly statement in a prescribed form. It was obliged to buy gold at the fixed price of £3-17*s*.-9*d*. per standard ounce and to sell gold in bars at the mint price of £3-17*s*.-10½*d*. per ounce.

Subsequent crises developing in 1847, 1857 and 1866 pointed to the inelastic nature of the fiduciary issue fixed by the Bank Act of 1844 and to cope with those crises the provisions of the Act had to be suspended making way for a further increase of the fiduciary issue. The Great War of 1914 disclosed the rigidity of the Act

of 1844, which proved a failure in the war situation. So the Act had to be virtually suspended and the situation was met by the issue of currency notes in denominations of £1 and 10s. by the Treasury.

In the year 1918 the Cunliffe Committee was appointed to investigate into the conditions of currency and foreign exchange in Great Britain and recommended a certain measure of elasticity in the currency system. Those recommendations were given shape by two Acts, *viz.*, the Gold standard Act of 1925 and the Currency and Bank Notes Act, 1928. Under the latter Act, the fiduciary issue of notes was raised to £260 million, subject to further alteration after consultation between the Bank authorities and the Treasury. The Bank was authorised by the Treasury to increase its fiduciary issue to £275 million as from the 5th August, 1931. The authority given by the Treasury to exceed the maximum limit is required to be laid before both the Houses of Parliament.

The Currency and Bank Notes Act, 1939 introduced a notable change in the system of note-issue. Under that Act the assets constituting the backing of the Bank's note-issue have to be revalued every week at market prices and any discrepancy between the two is to be made up not by the adjustment of note-issue to the assets, but by the reverse process of adjustment of assets to the outstanding note-issue by transfers of gold or securities to and from the Exchange Equalisation Account, as the case may be.

The Bank rate provides a potent weapon in the armoury of the Bank of England for carrying out its functions and pursuing its monetary policy. The Bank rate is the rate at which the Bank of England discounts the bills of exchange. In times of financial stringency when the bill-brokers do not ordinarily obtain finance from the joint-stock banks, they go to the Bank of England for rediscounting of bills. In such a position the 'market is in the Bank'. Before the first world war the Bank rate was the instrument predominantly used by the Bank to influence the credit policy. Now-a-days, it is being supplemented by other devices. Mr. Montague Norman, the ex-Governor of the Bank of England, believed that the internal effect of a change in the Bank rate was much more psychological than real.

The Bank of England increases or decreases the Bankers' balances and thus extends or diminishes the basis of credit by open market operations.

Besides being the Government's Banker, the Bank of England acts as a Bankers' Bank by keeping their balances and rediscounting their bills in time of necessity. The Bank renders a useful service by settling Clearing House balances on behalf of the clearing banks. It does not compete in any way with the joint-stock banks and operates in the country through nine of its branches.

It receives deposits and opens drawing account for a person properly introduced. The Bank discounts bills for its customers and makes advances on approved securities. Interest and dividend on customers' securities are collected, for which no service charge is made.

The Bank of England is proving its usefulness by subscribing to the capital of some corporations providing agricultural and industrial finance. It is gratifying to learn that the Bank has kept pace with the march of events by discarding the traditional policy of central banking and has now actively associated itself with the economc regeneration of the country. Its organising a subsidiary company, namely the Securities Management Trust Ltd., to assist industrial re-organisation in November 1929 was an eloquent testimony to its growing awareness of the country's needs and its changed role.

Structural Changes Introduced by the Bank of England Act, 1946

The above Act provides for the transfer of the existing capital-stock of the bank to the Treasury ; for the appointment by the Crown of a Governor, a Deputy Governor and Directors, for enabling the Treasury, after consultation with the Governor, to entrust the management of the Bank to a Court of Directors, reduced from 24 to 16 ; and for enabling the Bank to request information and make recommendations to the bankers.

Under the terms of compensation stock-holders of the Bank will receive £400 of new Government stock for every £100 of the Bank of England stock held. Government stock will bear the rate of 3% per annum which is reducible by the Government option only after April 5, 1966, thus guaranteeing stock-holders a 12% return for the next 20 years—the same as they have been getting for the past 20 years.

The Bank will pay to the Treasury each half-year the equivalent of what the Treasury must pay to the holders of new Government stock and thus nationalisation is a little more than a book-keeping transaction.

The term of the Governor and Deputy Governor has been extended up to five years instead of 2 years which was the rule previously.

The Chancellor of the Exchequer will be responsible for the banking policy and promises have been given that there shall be no day-to-day interference in the administration of the Bank.

The effect of the above provisions will be hardly visible to the general public. Significantly on this matter the Chancellor of the Exchequer states that the measure brings into legal form what has long been an accepted practice. The legal position will be that in an extreme case of disagreement between commercial banks, the Bank of England and the Treasury, public interest can be made to prevail over banking interest, and the Government which can be criticised in Parliament, will have final responsibility which most people believe that it should have, and in practice it long has had. The Act might have more implication for commercial banks, since the above provisions might mean almost anything.

Acceptance Houses

These business houses, as the very name suggests, are specialised in accepting bills drawn by their affiliated concerns or constituents against goods exported by them to different parts of the world. These firms were originally merchants and became bankers at a later stage of their existence. Most of these merchant bankers are of foreign origin and their business connections were in foreign countries. Now these have merged their personalities in England and their interests are bound up with the fortunes of this country. They have correspondents abroad and specialise in the geographical distribution of their business. These houses are mostly partnership firms and the partners themselves are respon-ible for the loss or profits of these concerns. Their experience and i·ıacy of contact with clients put them in an enviable position the money market.

They maintain accounts with the Bank of England but their working accounts are kept mostly with the clearing banks. They borrow money from the clearing banks occasionally and lend these out to the money market for a short period. Their functions are in the main the following:

(*a*) the receipts of deposits from their clients,
(*b*) operations in foreign exchange,
(*c*) the acceptance of bills.

Some of them, like Samuel Montague & Co., are bullion-brokers and some act as issuing houses as well. These houses submit periodical returns of deposits held by them on account of foreigners to the Bank of England and invest these funds in purchasing bills in the London market and also in Treasury bills.

Before the last Great War foreign exchange business was transacted practically by these merchant bankers. Still to-day they do a considerable arbitrage business in foreign exchange.

The most important part of the business is the acceptance of bills. The purchaser of imports opens a Letter of Credit with a merchant banker against which the foreign seller can draw bills supported by the bills of lading, insurance policy and invoice, which will create securities acceptable to the accepting houses. Such business requires a highly specialised degree of knowledge of foreign markets and conditions, and of the nature and saleability of the commodities against which credits are granted and also a shrewd judgment of the financial position and general creditworthiness of the clients to whom credits are granted.

Merchant bankers accept, *first*, against goods which are imported into this country, *i.e.*, Great Britain ; *secondly*, against goods which are exported from one overseas country to another overseas country ; *thirdly*, against exports from this country ; *fourthly*, and recently to a growing extent, against goods produced and for sale in this country, or during process of export ; *fifthly*, drafts in anticipation of the issuance of a loan ; *sixthly*, bills drawn against the sale from here to the U.S.A. of stock exchange securities which are attached to the bill ; *seventhly*, bills drawn by the hire-purchase financing institutions against credits granted by these institutions for instalment buying ; *eighthly*, bills are still drawn occasionally, in anticipation, for instance, of the shipment of cotton ; *ninthly*, bills drawn against the shipment of bullion.

These houses do also accept internal bills but the deposit bankers do not look with favour upon the practice of acceptance of the internal bills by the merchant bankers. The merchant bankers' business is, by accepting a bill, to provide the seller with the means of obtaining cash from the discount market or from his deposit-bank at a cheaper rate. For this acceptance they do charge some commission.

These acceptance houses have been criticised from time to time for providing a channel for the influx of some foreign short-term balances in London, which being 'hot money' are considered to be detrimental to monetary stability. Sometimes they are also criticised for some of their activities like the financing of foreign domestic trade, which accentuates the keenness of competition with the English business men.

With the decline in foreign capital issues, anticipatory bills, finance bills, considerable shrinkage in the volume of interport trade and *entrepot* trade, the future of the acceptance houses is obscure. Their banking side is also faced with a great set-back due to the incidence of the death duty and the limited supply of exceptionally efficient personnel. It has rightly been said that *"whatever the future may bring forth the degree of intimacy which has existed between merchant bankers and their clients is a part of city business life, the disappearance of which could only have cause for regret"*.

Discount Market

The discount market holds a unique position in the money market of Great Britain, the counterpart of which is not visible in any other country. The discount market is one which lives by borrowing liquid funds for the purpose of investment in bills with the right of recourse, in times of need, to the Central Bank. It provides the clearing banks with bills to be kept in their portfolio having varying maturities. *Secondly*, it produces an outlet for the short-term funds which seek investment. The business of the discount houses is carried on mostly by borrowed funds, while their owned capital is used as a margin.

The discount houses borrow money from their bankers on a short term like a day, a week or at call. They are in a position

to repay the borrowed money at a short notice, as they have access to the Bank of England for rediscounting their bills in times of necessity. Thus these discount houses act as intermediaries between the joint-stock banks and the Bank of England, as the latter's rate influences the money market indirectly through the discount houses. When money is recalled by the joint-stock banks from the discount market, these funds will go to some other quarters and the discount houses will tap again these sources for borrowing of funds. The ultimate lenders are the bank-depositors and the discount houses provide the lenders with an added security either by endorsing the bills or guaranteeing them. The discount houses purchase bills covering consignments of hemp, hides, food, hessian cloth, etc. The discount brokers have extended their business by discounting such bills against which the Bank of England will be prepared to advance money to the discount market. Consequently, the discount houses have taken largely to dealings in Government securities, especially the short-dated securities of the British Government. They feel inclined to make profits by 'jobbing' in these bonds, *i.e.*, by selling at a high price and repurchasing them when the market falls. Sometimes they add to their profits by 'jobbing' in money as well, *i.e.*, by borrowing at a low rate and lending out the same to the money-brokers on the stock exchange at a higher rate. Now-a-days, it may be said that "the discount market, which formerly was mainly concerned as a channel for providing the means by which a considerable part of the trade—particularly the international trade of the country was financed —has become largely a part of the machinery for facilitating short-term Government finance". The function of the pre-war (1914) discount market was to handle commercial bills, of which business the members of the market had a highly specialised knowledge. To-day this is only a part, and possibly not the major part of the business of the market ; other part is the making of profits out of operations in Treasury bills and short-dated Government securities. Unless commercial bills are increased and greater interest is shown in the negotiation of bills connected with hire-purchase or instalment buying, the discount brokers will be left with depleted sources of business and the inevitable result will be the amalgamation of some such houses or elimination of some. It was pointed out by the Chairman of Alexander's Discount Co. Ltd. in 1938:

"Our discount business consists in the main of obtaining money from the bank at a ½ per cent and employing it in the purchase of Treasury bills at a price which averaged in 1937 1/16 per cent. I need hardly tell you that a margin of about 1s. 3*d*. per cent does not cover our working expenses, let alone provide a dividend for our share-holders."

"The London discount market is the most remarkable feature of the city, and is an institution which has no equivalent in any other centre. It forms a sort of reservoir whose waterline registers the ebb and flow of monetary currents. The circle of houses which specialises in the practice of discounting constitutes a market wherein the offers of and demands for bills are adjusted against the offers of and demands for money on day-to-day or short notice. They are the intermediaries through which the markets, the money market and discount market can communicate and complement each other.

FEDERAL RESERVE SYSTEM IN THE U.S.A.

The financial crisis that took place in America in 1907 indicated the desirability of a centralised banking organisation in that country. It was then felt that in the absence of a Central Bank it was not possible to control any financial crisis by affording succour to the banks in times of emergency. Accordingly a Monetary Commission was formed in 1908 to consider this question. On the basis of the recommendations of that Commission the Federal Reserve Act of 1913 was passed.

The Federal Reserve System was established mainly with a view 'to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the U.S.A. and for other purposes'. Under the Federal Reserve Act of 1913 the country was divided into 12 districts, for each of which one Federal Reserve Bank was set up. Thus in the U.S.A. there exists 12 Federal Reserve Banks which present a picture of decentralised banking. But in order to exercise a centralised control over the banking system of the country, a central co-ordinating body called the Board of the Governors of the Federal Reserve System was formed.

As reconstructed by the Banking Act of 1935, the Board is composed of *seven* members appointed for a term of 14 years by the President with the concurrence of the Senate. These members are not eligible for reappointment after they serve their full term of 14 years. The Board enjoys extensive powers including the management of the affairs of these 12 Federal Reserve Banks, supervision and regulation of the issue and retirement of Federal Reserve notes, determination of the discount rates, handling of open market operations, suspension or alteration of the reserve requirements, examination of the returns from members etc., and supervision over the foreign exchange operations of the Federal Reserve Banks.

Federal Reserve Banks.—These Banks, though under the supervision of the Federal Reserve Board, are not Government institutions or commercial banks. Their capital is subscribed by the member banks of the district in which they are situated and their functions are designed to serve national interest. There is a restriction of dividend up to 6% *p.a.* A Reserve Bank has nine Directors, three of whom are appointed by the Board of Governors of the Federal Reserve System, and one of these is the Chairman and the other Vice-Chairman. The other six Directors are elected by the member banks who are the shareholders. The business in which these Reserve Banks can engage has been enumerated by the Federal Reserve Act. Unlike in Great Britain, these Federal Reserve Banks do not show separately the position of the Banking and Issue departments.

Classification of Banks

(*a*) National Banks by the Federal authorities.
(*b*) State Banks chartered by the State authorities.
(*c*) Member banks.
(*d*) Non-member Banks.
(*e*) Insured Banks with the Corporation (F.D.I.C.).
(*f*) Uninsured Banks.

National Banks.—National Banks were regulated by the National Bank Act of 1864. Any number of persons, not less than five, may organise a National Bank with the approval of the Comptroller of the Currency. No new National Bank may commence

business until it has a paid-up surplus of 20% of its capital subject to certain exceptions.

A National Bank cannot make any loan or discount on the security of its own shares, nor hold or buy its own shares, except where no other security is available, subject to the disposal of these shares within six months No National Bank is now permitted to invest in premises or real estate in excess of its capital, except with the approval of the Comptroller of the Currency. A National Bank cannot pay interest on deposits more than the prescribed maximum. Every National Bank is required to submit at least three reports a year to the Comptroller of the Currency. The Comptroller has the right to examine any such bank.

State Banks.—State Banks are governed by the law of the states.

Relationship with Member Banks

All National Banks are required by law to be members of the Federal Reserve System. State banks may apply for membership, but are admitted only after the Board of Governors has considered their financial condition, the general character of their management, and whether or not their corporate powers are consistent with the Federal Reserve Act.

Member banks are required to keep statutory reserves with a Federal Reserve Bank against their demand deposits in the following scale:

Central Reserve City Banks *(New York and Chicago)*	...	...	13%
Reserve City Banks	...	...	10%
Other Member Banks	...	...	7%

Reserves of the member banks have the following characteristics: (*a*) They are statutory reserves ; (*b*) there is a differentiation between the reserves of town and country banks ; (*c*) bigger reserves are required against demand than against time deposits.

Dealings in Securities re: Member Banks

Certain restrictions have been imposed on dealings in securities by the Banking Acts of 1933 and 1935. Member banks are

authorised to purchase and sell securities on account of their customers and are prohibited from underwriting new issues. Banks are, however, permitted to purchase investment securities for their own account under such terms as will be prescribed by the Comptroller of the Currency and cannot invest more than 10% of capital and surplus in marketable bonds, notes or debentures.

The Federal Reserve Board fixes from time to time appropriate limits, which may safely be secured by stocks or bond collateral. It is "the duty of the Board to establish such percentages with a view to preventing the undue use of bank loans for the speculative carrying of securities". The Board 'has the power to direct any member bank to refrain from further increase of its loans secured by stock or bond collateral for any period up to one year, under penalty of suspension of all rediscount facilities at Federal Reserve Banks'. The Act of 1933 prohibits any member bank from making advances to stock-brokers or security-dealers as agent for any non-banking person. The Board also fixes the maximum percentage of advance that is permissible against the market value of stocks and securities. This margin requirement provides an effective instrument for the controlling of credit to speculators. Far-reaching proposals for strengthening control over the expansion of credit were suggested by the Federal Reserve Board of Governors in its annual report at the end of July, 1946. They sought for additional powers to—

(*i*) limit the volume of long-term marketable securities held by a commercial bank against net demand deposits,

(*ii*) to require all commercial banks to hold a specified percentage of Treasury bills and certificates as secondary reserves against net demand deposits and

(*iii*) to raise reserve requirements within some specified limits against net demand deposits.

Limitation of Rediscount

Rediscounting facilities are offered against certain types of eligible paper. No Federal Reserve Bank can rediscount for a State member bank the notes, drafts or bills of exchange of any borrower who owes that bank a greater sum than he would be permitted to borrow from it, were it a National Bank.

Dealings with Non-Members

No member bank is permitted to deposit any sum in excess of 10% of its capital and surplus with any non-member bank. The purpose is to prevent any bank, not included in the Federal Reserve System, from deriving any benefit from the System.

Acceptances by Member Banks

The outstanding acceptances by any member bank may not exceed 50% of its capital and surplus. Bills not supported by documents of title to goods, etc., may not be accepted by any bank in excess of 10% of its capital and surplus for any one customer.

Rediscount Rate

The traditional method of credit control is the manipulation of the rediscount rate. In England it is an effective weapon, for the market rates move up and down according to the rise and fall in the Bank rate. But in the U.S.A. a complex of rates prevailing in the market prevents the emergence of the same results from a change in the rediscount rate. Moreover, the rediscounting facilities that are available to a member bank always counteract the results that are sought to be achieved by a change in the rediscount rate. The Federal Reserve authorities never agree as to whether the rediscount rates should be penal. Besides these disagreements, there remain some practical difficulties in making the rate penal. *Firstly*, member bank rates being already high, it becomes impracticable to raise the rediscount rate higher still. *Secondly*, the rates of member banks being different, what would penalise one bank might encourage another to rediscount. *Thirdly*, changes in the rate will not affect loans at call. *Fourthly*, there is a strong feeling in the U.S.A. that trade and industry must be accommodated at all costs, and as a result it becomes impossible to curtail accommodation by raising the rate. *Fifthly*, the purchase of bankers' acceptance by a Federal Reserve Bank according to banking convention, stultifies the rediscount policy, as it did in 1929.

Open Market Policy

In the U.S.A. the open market policy has a restricted sense, for it refers only to sales or purchases by the Reserve Banks of Government securities. Of the other instruments they mostly purchase bankers' acceptance, but do not sell. The policy is framed by the Federal Open Market Committee. Such operations are held to prepare the way for the rediscount policy. But the policy is not a strong force in creating an expansion of credit. The success of the policy depends on the following conditions: (*a*) sales can be successful if there is a reasonable market in Government securities and the Reserve Banks should purchase ahead large portfolios of securities; (*b*) care is to be taken that the Federal Reserve Policy does not embarrass the Treasury; (*c*) gold movements may destroy the effect of security operations, which should be guarded.

Change in the Reserve Ratios

In the U.S.A. it had the effect of immobilising the excess reserves, whereby it becomes easier to control the credit base by the normal instruments of credit policy, *viz.*, rediscount rate and open market operations.

Interest on Deposit

No interest is payable on demand deposits. The rates for time deposits have been fixed by the Board. This idea is inspired by the fact that high deposit rates strike at the root of sound banking.

Reasons for Regulated Banking in the U.S.A.

(*a*) Banking in the U.S.A. was up till the time of the civil war managed by the inexperienced people lacking in any banking tradition, as we found in England in the case of the private bankers. The lack of experience combined with lack of supervision made regulation inevitable.

(*b*) Due to frequent fluctuations in values, American bankers have developed a speculative outlook on life, for which regulation by legislation was necessary.

(c) The continued existence of the unit banking system necessitated the fulfilment of certain legal requirements, which would not have been necessary if branch banking were developed under instructions of the Head Office. Moreover, crops of bank failures made the agricultural elements of the country distrustful of finance, for which statutory regulation of banking was necessary.

Note-Issue.—Every Federal Reserve Bank is required to maintain reserves in gold of not less than 40% against its Federal Reserve notes in actual circulation, and reserves in gold or lawful money of not less than 35% against its deposits. Should the reserves fall below the statutory limit of 40% ratio, the Federal Reserve Board is authorised to impose a graduated tax upon the excess issue.

Federal Deposit Insurance Corporation (F.D.I.C.)

The Federal Deposit Insurance Corporation was established by the Banking Act of 1933 to insure the deposits of commercial banks against failure. The Corporation was started in 1934 with a capital of $289.3 million, subscribed partly by the Treasury and partly by the Federal Reserve Banks. It is controlled by a Board of three Directors, the Comptroller of the Currency being one. Each of the customer's deposits is insured up to $5,000 and banks are to pay an annual premium of 1/12 of 1% of their total deposits. Federal Reserve member banks are compulsorily to insure their deposits with the Corporation. The scheme has been appreciated by a large body of the public and the majority of the banks have participated in the scheme. The new Federal Deposit Insurance Act, which came into force in 1950, has reduced the cost of insurance for banks by a half, and at the same time doubled the coverage of protection per deposit account from $5,000 to $10,000.

The Corporation will admit new members on being satisfied about the general character of the management of the applicant bank, the adequacy of the capital structure, the future earning prospects etc. It is widely held that the scheme will be an instrument in preventing overbanking in the U.S.A. where mushroom banks are reported to spring up in times of prosperity.

The Corporation reserves the right to terminate the insurance of the member banks, which follow unsound banking policy, after reference to the Comptroller, the Reserve Board or the state banking authorities in the case of non-member banks. It has the right, with the previous permission of the Comptroller and the Board of Governors, to examine any insured bank, whenever necessary. Insured State non-member banks cannot open new branches or change the location of their office-premises without the consent of the Corporation. The controlling provisions of the Corporation are a curious combination of restraints and requirements.

The functions of the Corporation have been described in the report of 1937:

> "The decrease in the number of insured banks (in 1936) resulted in part from a definite programme of eliminating insolvent and weak banks, either by closing them or merging them with sound banks with aid from the Corporation, in part from mergers and consolidations, and in part from the exercise of control by supervisory authorities over the chartering of new banks."
>
> "The Corporation favours the establishment of banking facilities in every community which can furnish sufficient justification for banking service, but it opposes the chartering of institutions which it believes to be economically unsound and likely to fail. It has received the co-operation of most of supervisory authorities in preventing the indiscriminate chartering of banks........"
>
> "The Corporation is insisting that banks under its supervision take their losses when they occur, in order that their true condition may be reflected. It is insisting that banks maintain adequate capital structure and that banks which seek to retire their preferred capital shall retain capital sufficient to provide protection against the uncertainties of banking operations. It is taking action against banks which continue to engage in unsafe and unsound practices."

The June, 1951 report of the Corporation reveals that during the five years ended December, 1950, it conducted nearly 30,000 regular examinations of insured banks thus fostering sound banking practices, and completed the liquidation of

145 banks. At the end of June, 1951, 90% (13,652) of the total number of banks and 95% of the total deposits in the U.S.A. were insured by the Corporation. The insured banks had 104 million deposit accounts of which nearly 99% were fully protected by the Corporation. During the 17½ years of its existence the Corporation disbursed \$322 million for protecting 1,355,000 depositors in 416 insured banks. The whole amount except \$26 million is expected to be recovered.

The question of the feasibility of starting such an institution has of late focussed much public attention in India. As the insurance scheme of the U.S.A. was "born of the holocaust of bank failures and the bank holiday of 1933", there was a greater necessity for promoting such an institution in India which witnessed crops of bank failures for the last half a century. The depositors suffered immensely from such repeated failures, which had a weakening influence over the banking structure of the country. Some economists are of opinion that the creation of such a Corporation on the model of the American scheme under the direct initiative of the Central Government would give a powerful support to the banking fabric of the country, because of the fact that such an institution would be inspiring confidence in the depositors and generate in them a sense of security that the entire credit and weight of the Government lie behind the banks. From the point of view of idea, it is good no doubt but how far will it be practicable to fit in the existing pattern of banking is the question for thought. The item of cost involved is to be considered. It is to be ascertained how far will the insurance cost encroach upon the profits of the banks and make credit costlier, when the necessity is for a cheaper credit.

The next point for consideration is the insurability of the risk of bank failures. It is debatable how far such a risk can be amenable to calculation on a sound actuarial basis. As Mr. H. Jones points out, neither the risk is strictly an insurable one, nor the allocation of cost according to benefit is practicable. "The major factor militating against the insurability of risk is the catastrophic hazard involved."

Moreover, as will appear from a perusal of the American Insurance Scheme, most of the functions of the Corporation relating to the opening of new branches, change of location of the offices,

merger and amalgamation of the banks, etc. are now being discharged by the Reserve Bank of India. New branches cannot be opened, nor the location of the bank offices be changed without the previous consent of the Reserve Bank of India. Schemes of merger and amalgamation cannot be executed without the approval of the Reserve Bank of India in terms of Section 44A of the Banking Companies Act. The issue of further capital cannot be made without the recommendation of the Reserve Bank of India. Just as the American Corporation lays down certain tests of eligibility for admission of a new bank for the facilities of deposit-insurance, so does the Reserve Bank while admitting any bank to the Second Schedule to the Reserve Bank of India Act, 1934. Under Section 42(6) of the Reserve Bank of India Act the Reserve Bank has the right to exclude any scheduled bank following unsound and unsafe banking policies from the Second Schedule and also to prohibit it from accepting fresh deposits. About the Federal Deposit Insurance Corporation, it has been said that "if it succeeds in the future only in preventing overbanking, it will perform an invaluable service for the country". But the same service is now being rendered by the Reserve Bank of India under Section 23 of the Banking Companies Act, 1949. On the admission of the Corporation, the scheme is "not a wonder drug" curing all ills of the banking system as well as the unstable business conditions which in the past culminated in bank crises. The soundness of the banks is ultimately related to economic conditions ; and the solvency of the banks in the future as in the past, while dependent in part upon the soundness of individual bank managements, will be controlled in large measure by general economic condition and monetary credit developments. In 1954 the Committee on Finance for the Private Sector in India, went into this question of having a bank deposit insurance scheme similar to that obtaining in the U.S.A. and felt that it should merit further examination by banks and recommended that it should be adopted, if, after detailed examination, there is consensus of opinion amongst banks in the matter.

The Deposit Insurance Corporation

After the failure of two scheduled banks in India in 1960, it was felt that a Corporation should be established with a view to

providing insurance cover to a specified extent against loss of deposits with commercial banks in India. Accordingly, the Government of India decided in 1961 to constitute such a corporation and passed a legislation called the Deposit Insurance Corporation Act, 1961 which received the assent of the President on the 7th December 1961. The Act came into force on the 1st January, 1962 and the Deposit Insurance Corporation came into existence on the same date.

The authorised capital of the Corporation shall be Rs. 1 crore fully paid up and shall stand allotted to the Reserve Bank of India. It is managed by a Board of Directors composed of (*a*) the Governor for the time being of the Reserve Bank who shall be the Chairman of the Board, (*b*) a Deputy Governor of the Reserve Bank nominated by that bank ; (*c*) an officer of the Central Government nominated by that Government and (*d*) two directors nominated by the Central Government in consultation with the Reserve Bank having special knowledge of commercial banking or of commerce, industry or finance, neither of whom shall be an officer of Government or an officer or other employee of the Corporation or a director, an officer or other employee of a banking company or otherwise actively connected with banking. The Head office of the Corporation shall be at Bombay.

Every existing banking company *i.e.* a banking company carrying on the business of banking on the 1st January 1962 shall be registered by the Corporation as an insured bank. The Corporation shall also register every new banking company as an insured bank as soon as may be after it is granted a licence under section 22 of the Banking companies Act, 1949, or, as the case may be, after it is notified under section 51 of the said Act. The registration of an insured bank shall be cancelled if the bank concerned is prohibited from receiving fresh deposits, refused a licence to carry on banking business, ordered to be wound up, goes into voluntary liquidation, transfers all its deposit liabilities to any other institution and is amalgamated with any other banking institution. Each ,positor other than the Central and State Governments, a foreign overnment or a banking company is ensured a payment of 's 1,500 on the total amount deposited by him in the same right capacity, whichever is lower. Every insured bank is required pay periodically to the Corporation a premium at 5 naye paise

per annum for every hundred rupees on its total deposits in India excluding deposits of a foreign Government, the Central Government and a State Government and inter-bank deposits. The maximum premium which the Corporation is empowered to charge is 15 nP. An insured bank is liable to be charged interest at a rate not exceeding 8% per year if it defaults in the payment of the premium.

Out of the total deposits of nearly Rs. 1,900 crores in the banks as at the beginning of 1962, the deposits that come within the purview of the Deposit Insurance Scheme are estimated at Rs. 1,500 crores.

CANADIAN BANKING SYSTEM

The Canadian banking system consists of the following: (*a*) the deposit or "chartered" banks, (*b*) two hundred co-operative banks granting loans on mortgages, (*c*) one hundred investing banks or 'bond houses', (*d*) loan, mortgage and trust companies, (*e*) rural credit institution, (*f*) the Quebec Provincial Government and Dominion Government Savings Banks, (*g*) the Bank of Canada.

Chartered Banks

The chartered banks number 10 and have a network of about 3000 branches all over the country. These are commercial banks undertaking commercial operations and financing the imports and exports of the country. These chartered banks are governed by the Bank Act.

The Bank Act requires every chartered bank to have a capital of $500,000 of which at last $250,000 must be paid up. Dividends are limited to 8% per annum unless the banks' reserve fund becomes equal to 30% of the paid-up capital. Every chartered bank must be managed by a Board consisting of at least five Directors. Proposals were placed before the Royal Commission of 1933 for prohibiting bank Directors from being Directors of other companies. But the proposal was declined by the Commission. The law forbids any bank's officer to serve as agent for an insurance company or to put pressure upon any borrower to offer as security policy in any particular insurance agency. A bank is not permitted to allow loan

exceeding 5% of its paid-up capital to any Director or to any company in which the Director or general manager of the bank is a partner or a shareholder.

Every chartered bank is to keep with the Bank of Canada 5% of the deposit liabilities in Canada and is not permitted to withdraw these reserves. "Canada belongs to that group of countries in which cash reserves do not so much secure liquidity in time of emergency as protect depositors in the case of ultimate liquidation." Minimum liquidity ratios were introduced in mid-1956 and set at 15% of deposits. These ratios included among eligible liquid assets (in addition to cash and day-to-day loans to Government securities dealers) instead of the broad range of Government securities.

These chartered banks still possess the authority to issue notes but since the inauguration of the Bank of Canada in 1935, these issues are to be superseded gradually by the Central Bank notes. The business and powers of these banks are defined by law, but certain types of business as given below are forbidden: Sale and purchase of goods, engagement in any trade or business whatsoever ; the sale and purchase of, or contraction of loans against, the capital-stock of any Canadian bank ; loans to Directors without the approval of two-thirds of the directorate. Under section 88 of the Bank Act a bank may lend money to any wholesaler, purchaser, or shipper of or dealer in products of agriculture, the forest, the quarry and mine, or the sea, lakes and river on the security of such products ; to farmers on the security of threshed grains ; to wholesale manufacturers on the security of goods, wares and merchandise manufactured by them or procured for manufacture ; to owners or trusts of land for the purchase of seed or fertiliser, on the security of prospective crops ; to a person engaged in stock-raising upon the security of livestock. But there was some particular feature of this sort of advance in this respect that the borrower retains the goods in question in his ownership and possession, delivering to the bank no documents of title to goods, but a simple assignment which gives the Bank the first lien on the goods. Such an assignment was required to be registered. In 1948, 1951 and 1955, the Central Bank proposed that the chartered banks cease most forms of 'term' blending and the banks agreed.

Banks are prohibited from speculating in land, although they permitted to accept mortgages of land as *additional* security.

The rates of interest have been fixed by law at 7% and collection charges @ $\frac{1}{8}$%. Such regulation of bank charges is uncommon in commercial banking legislation.

The control of commercial banking in Canada rests with the Minister of Finance. The next important authority is the Treasury Board. The Inspector-General of banks is to examine at least once a year the affairs of each bank and submit a report to the Minister of Finance. Then there is the Canadian Bankers' Association which acts as an adviser to the Treasury Board. Lastly, the Governor-General discharges certain functions in banking control. On the whole, Canada has a multiplicity of supervising authorities.

BANKING SYSTEM OF JAPAN

The Japanese banking system is akin to the English system of banking. It is imbued with liberality and is free from legal regulations. The authority of the Bank of Japan over the money market and the banking system is incomplete. Japan possesses a number of smaller banks, the standard of which has got to be raised. And for this purpose detailed regulations are needed. The control of the Central Bank of Japan is to be widened in a manner that the constituent elements of the money-market may come under its influence.

In 1872 the National Bank Regulations provided for the replacement of the exchange companies by national banks, possessed of the right to issue notes convertible into specie. Besides the national banks, there existed some private banks which had no right of issuing notes. In 1882 sweeping changes were introduced in the banking system by the *formation of the Bank of Japan* with a monopoly of note-issue and the creation of distinct groups of banks confining their activities to specialised fields, such as long-term industrial finance, agricultural credit, foreign exchange dealings etc. In 1890 a banking code was framed requiring all banks to obtain a licence from the Ministry of Finance and to submit half-yearly reports to the Ministry of Finance which may order examination at any time. Detailed regulations governing the operations of savings banks were also drawn up in 1890 and had to be amended in 1922. These banking regulations did not apply to special banks, like the Hypothec Bank of Japan, Yokohama Specie Bank, Industrial

Bank of Japan, Hokkaido Colonial Bank, etc. which were distinct from ordinary commercial banks. Besides these, there are Trust Companies which were prohibited from undertaking general banking business. Most of the commercial banks in Japan have formed Trust Companies of their own to undertake trust business.

The Financial System Investigation Commission was appointed in 1926 to examine matters, relating to the improvement of the banking system of the country and on the basis of those recommendations a Bank Act was passed in 1927. Under the Act banks are required to be organised as joint-stock companies. A Bank cannot open any branch, sub-office or agency or change the location of, or convert sub-offices into branches without the licence from the Ministry. An amalgamation requires the written consent of the Ministry of Finance.

Normally the minimum capital required of a bank is 1 million yen, but the requirement is doubled for opening branches in districts specified by the Imperial Ordinance. 10% of profits are to be transferred to the Reserve Fund till it becomes equal to paid-up capital. There is no restriction on the nature of assets which a bank may hold. To examine the banks and to keep a ready check on them, there is a Bureau of Banking of the Finance Department.

The Bank of Japan keeps the accounts of different banks but their balances are usually inadequate. Though the Bank of Japan is looked upon as the 'lender of last resort', still its control over the money market is far from satisfactory. It was pointed out by a former Minister of Finance that "the official discount rates of the Bank of Japan have little relation with market rates, which always anticipate the former. The change in the official rates has, therefore, taken place more for the purpose of acting as a warning signal than by reason of an established discount policy". Legislation was enacted in 1957 to establish variable cash requirements according to a geographical classification. Import-predeposit requirements have also been adopted.

The Export Bank of Japan

The Export Bank of Japan was established on December 28, 1950 with the principal objective of catering to the long-term requirements of capital goods industries for exports. The need for such

a specialized institution had been keenly felt in Japan, the development of whose economy depends to a considerable extent upon exports. The Export Bank will supplement the finance made available for the purpose by ordinary financial institutions and not compete with them. The Bank will provide credit only when the entire financing of an export contract by banks is considered difficult or undesirable, and only in participation with them. In addition to making loans, the Bank may assist in supplying technical services by Japanese Corporations or individuals.

The capital of the Bank is Yen 15 billion subscribed by Governments ; partly out of its own resources and partly from the U.S. Aid Counterpart Fund. The management of the Bank, which is largely independent of direct Government control, consists of a President, a Managing Director, not more than three Directors and not more than two Auditors. The President and Auditors are appointed by the Prime Minister, and the Managing Director and Directors by the President. The duration of operation of the Bank has been limited to five years.

Though there is no special limitation in respect of the amount of the loan to be granted in individual cases, ordinarily the Bank's share should not exceed four times the sum to be provided by participating banks. The loan is repayable to the Export Bank in not less than six months and not more than three years ; the time may be extended to five years in special cases. The rate of interest on loans is to be fixed on a basis so as to cover all expenses and possible losses.

The Bank is prohibited from accepting deposits, borrowing funds, issuing debentures or engaging in domestic or foreign exchange business. It can employ its idle funds in the purchase of Government bonds or deposit them with the Ministry of Finance or with the Bank of Japan. The Export Bank is required to submit its annual budget to Government and will give effect to it only after approval by its Diet.

BANK OF FRANCE

The Bank of France was first founded by Napoleon Bonaparte in the year 1800. The purpose of the Bank, according to its original constitution, was to remedy by a combination of [illegible]

public and private, the disposition of the resources which constitute virtually the life-blood of commerce, and the debasement of public credit resulting from the Revolution.

The Bank is managed by a General Council, which consists of a Governor, two Deputy Governors, fifteen Regents and three Censors. The Governor and two Deputy Governors are appointed by the President of the Republic on the recommendation of the Finance Minister. Others are elected by the stock-holders of the Bank. The three Censors do not possess any voting power and devote themselves mainly to the supervision of operations for report to the stock-holders. The General Council is entrusted with the general administration of the Bank, the conduct of its operations, the control over note-issue and is to determine the general policy of loans and discounts. It is assisted by a Discount Council of shareholders consisting of twelve members.

The Bank, like other Central Banks, enjoys the exclusive right of note-issue. As regards the regulation of note-issue the Bank followed the principles of the 'banking school'. It was its policy right from the beginning that 'the guarantee of bank-notes ought not to be sought in the capital funds of the bank, but in the bills which it discounts'. Besides this, the Bank holds 35% reserve in gold coin or bars against total notes in circulation and deposits. Bank notes are in greater demand in France than in Great Britain, as the cheque habit there is not so well developed as in Great Britain. For many years the Bank has followed a consistent policy of maintaining a large metallic reserve for the redemption of outstanding notes in circulation.

The Bank has a close connection with the Government and is its principal banker. The Government, if necessary, may intervene in its administration. It keeps the Treasury balances, receives state funds etc. All payments on account of the Treasury are made by the Bank free of charges and the Rentecoupons are collected by the Bank without any service charge. Whenever required, the Bank has never hesitated to issue French Rentes or Treasury bills at the request of the Ministry of Finance, though it was not constitutionally bound to do so. Every facility is extended by it for the purchase and transfer of Government stocks and bonds. Besides these, the Bank on many occasions granted advances to the French Government. According to the convention established between the

Government and the Bank of France in June, 1928, it agreed to grant to the state an interest-free loan of fr. 3 milliards.

Bank's Relations with the Customers and the Public

The Bank of France transacts business on behalf of its permanent customers as well as of the public. An account may be opened with the Bank by any person on proper introduction. Overdrafts are not granted except on advance accounts and then against approved securities. It accepts articles for safe custody not only from its regular customers but also from those who may not have an account at all. For such services the Bank charges a commission. The Bank undertakes sale and purchase of stock exchange securities on behalf of its clients. All such transactions, which in ordinary course are undertaken by joint-stock banks, have exposed the bank to such criticism from certain quarters that the Bank of France is not a Central Bank in its true sense. It cannot be denied that the Bank, by undertaking such commercial transactions, has directly or indirectly come into competition with other joint-stock banks, whereas, according to the strict central banking principle, the Bank should have discarded such operatiohs and should have prudently left them to commercial banks.

Bank's Relations with other Banks

The Bank is to face competition from other institutions in the ordinary course of business and in times of necessity, lends financial assistance to other banks and helps in the restoration of confidence in the banking system. Some of the banks, such as Comptoir-d' Escompte, acted as intermediaries between the Bank of France and the trading community in the matter of discounts. As bills rediscountable with the Bank of France must have to bear three signatures, these banks become one of the signatories to the bills.

Discount Rate

The Bank of France so far maintained a low discount rate to establish easy conditions in the money market. In 1852-61 the

Bank once tried to stop the outflow of gold by raising the discount rate and was severely criticised for this policy. Later on the Bank had to abandon the policy of controlling the credit-condition by a manipulation of discount rates. So the discount policy was no potent weapon for the Bank of France to control credit in the country and through it, to regulate prices and production.

Open Market Operations

The Bank of France does not ordinarily engage in open market operations like other Central Banks. It is not authorised to buy or sell securities on its account. Under the stabilisation law of 1928 the Bank was permitted, as a reciprocal obligation, to buy or sell securities and bills at the request of foreign Central Banks. And such buying or selling at the instance of others cannot properly be called open market operations. The Bank of France can influence the credit conditions by dealing in foreign exchange only on a restricted scale.

In France it will appear from the foregoing that bank credit is not so important as in Great Britain and the U.S.A. The problem there is more of the collection and safe investment of small savings than of an extensive use of bank credit. So the technique, like discount policy or open market operations, is not required to be applied in France to control the credit base, as in that country the main concern for the Bank is the maintenance of easy monetary conditions and nothing else. The absence of such a credit-controlling technique in France also subjects the Bank to the criticism that it is not a Central Bank in the true sense of the term. In other countries constant research work is being done by their Central Banks to experiment with new technique of credit and price-control, whereas the Bank of France is to discard the application of such technique. The nationalisation of the Bank in recent years will show whether it will not revise its old policy and fall in line with the policy of central banking as pursued in other countries and thus develop into a full-fledged Central Bank.

The liquidity ratios were also introduced as a means of immobilizing the government securities portfolios of the commercial banks, thus rendering the banks dependent on the central bank "discount window". Import-predeposit requirements were in-

sisted upon to exercise quantitative and selective control over bank credit. Controls were also applied to instalment credit terms.

The Banking System of France

There are several broad categories of banking institutions operating in France. Apart from the Bank of France, which is now primarily the Central Bank, there are (1) the 278 deposit banks, some of them nation-wide in the scope of their operations, others limiting their activities either to Paris or to a particular region or locality ; (2) a rather smaller number of banques d'affaires—39 in all which in respect of part of their business may be regarded as investment banks ; (3) several groups of specialist institutions—7 discount houses (though not all of these are registered as banks), 2 bullion brokers, 8 banks lending specifically on medium and long-term, and 6 banks operating mainly in French overseas territories or in foreign countries ; (4) a number of foreign banks, of which 15 are incorporated outside France, 11 others being French companies under foreign control ; and (5) a miscellaneous group of 16 Algerian banks, 2 banks operating in the Saar and 4 "unclassified" (the last are mainly colonial banks). In addition to the registered commercial banks and the Bank of France, there is an important group of public and semi-public institutions, which help to provide the framework for the money market.

Three separate authorities are now responsible for the regulation of the banking system, though because of the strategic positions occupied by the Governor of the Bank of France and the effective liaisons maintained between the respective authorities, there has in fact been very little overlapping. The National Credit Council set up in 1945 is broadly responsible for general credit policy and advises the Government on all relevant matters. The Banking Control Commission, first established in 1941, is concerned with the supervision of the various groups of banks, on which it may impose sanctions if its requirements are not met. In certain matters, it also serves as an appeal tribunal. The Bank of France acts as the executive arm of authority and, in this capacity, possesses extensive powers to regulate both the volume of credit and the direction of lending. When necessary, it may impose penalty rates on accommodation sought from it by the commercial banks.

The Deposit Banks

The four largest deposit banks—the Credit Lyonnais, the Societe Generale, the Banque Nationale pour le Commerce et l'Industrie, and the Comptoir National d'Escompte—were nationalised in 1945, though each retained its separate identity and, despite government ownership of this important sector, business arrangements have remained fully competitive. All of these banks operate through a widespread network of branches covering the whole of the country. The two other grand establishments were not nationalised. The Credit Industrial et Commercial is technically a Parisian bank, its own branches in France being restricted to Paris and its environs, but it heads an important group of regional banks, in each of which it holds a capital interest, and the branches of the group as a whole cover the larger part of the country. The Credit Commercial de France has a less complete coverage of branches, but the spread of its interests is definitely on a national scale. Of the 22 regional banks (including those associated with the Credit Industrial et Commercial), the Credit du Nord is by far the largest and, indeed, ranks fifth in size for the country as a whole. All these banks in the scope and character of their business, are not greatly different from the large joint-stock banks in the United Kingdom. Their operations are based primarily on the receipt of deposits (about 75 per cent of their resources), the bulk of which is repayable on demand. Although their asset structures are somewhat different from British banks and accommodation is made available more generally by way of the discount of commercial paper, the broad nature of the business undertaken is essentially similar in the two countries. It is difficult to make exact comparisons, but the French banks are clearly much more pent up than their British counterparts. Treasury bills and similar securities (including discountable medium-term paper) amount only to about 15 per cent of total assets, whereas commercial discounts approximate 50 per cent. and loans and overdrafts (of the big banks) to 17 per cent. On the whole, the regional and, more particularly, the local banks are rather more liquid and this may be associated with the greater concentration of their risks.

Of the smaller deposit banks, there is quite a concentration in Paris, the most important being the private bankers—de

Neuflize, Schlumberger; Vernes; Lahideux; Mallet Freres; Hottinguer; and Veuve Demachy—whose activities are by no means confined to Paris, though they do not possess branches. In recent years, they have tended to extend the scope of their business, but for the most part it continues to be based on long-established connections with particular customers and new business is usually accepted only on the basis of introduction.

Although much less marked than in the United Kingdom, there has been some evidence in France of the trend towards greater concentration of banking business in the hands of a small number of large units. Thus, the four large nationalised deposit banks now account for about two-thirds of the total volume of business and there are three large non-nationalised banks, one heading a group of regional banks and another—the Credit du Nord—a very powerful regional bank. There are 9 independent regional banks left and 168 local banks in the provinces, but the last group is slowly shrinking and, over the years, there has been a definite tendency for the smaller banks either to die out or to be absorbed by, or associated with, larger banks.

The Banques D'Affaires

The banques d'affaires, which constitute the other major group of commercial banks, have long been interested in investment finance as opposed to banking proper, though in fact they also undertake an extensive commercial banking business. This remained true even after 1945, when the banques d'affaires were required to register specifically as such, but their deposit banking is now subject to restrictions within the terms of the legislation.

The banques d'affaires were defined as institutions, whose principal functions were to take up and administer "participations" in existing concerns, to assist in launching new ventures, and to open credits (subject to no specific limitation as to term) for public and private enterprises, which have benefited or which stand to benefit from such participations. For these purposes, they might employ, in addition to their own funds, only such deposits as had been accepted for a term of at least two years. None of the banques d'affaires was nationalised in 1945, but the larger institutions were made subject to the general supervision of a Govern-

ment Commissioner, who was attached to each institution for the purpose.

The Discount Houses

Of the several groups of specialised institutions, the only one which requires specific mention in considering the broad outlines of the French banking structure is that which includes the discount houses. On the whole, these are much smaller and very much less important in the money market than their London counterparts. Only one—the Compagnie Parisienne de Reescompte—is truly large and it is virtually the "official broker". As in London, the discount houses in Paris borrow from banks and other institutions for the purpose of carrying portfolios of bills for their own account, but from the point of view of the money market structure their functions as brokers are more important and it is through them—more particularly through the Compagnie Parisienne de Reescompte—that the Bank of France carries out its operations in the "open market."

The Public and Semi-Public Institutions

In France, there is an important group of institutions which in most instances have no parallel in the United Kingdom. The general purpose of these public and semi-public institutions, all of which are wholly or partly owned by the State, is to provide specialist facilities judged to be necessary in the furtherance of public policy. Broadly speaking, they may be grouped into two main categories: (*a*) those which help to integrate the market by forging links between its constituent members ; and (*b*) those which are mainly concerned with specialist lending.

THE REICHS BANK

The Reichs Bank or the Imperial Bank of Germany was reconstituted in that name in 1875. It underwent a thorough reorganisation again in 1924 according to the Dawes Plan. Though the Bank is directly under the control of the Reich, its shares are privately owned. It is now the Central Bank of Germany and is

mainly responsible for the maintenance of the financial stability of the country, its gold reserves, and management of note-issue. It is the ultimate source of credit in times of emergency.

Under the law of 1924 the Bank is managed by an Advisory Committee, a Managing Board and a General Council. The Advisory Committee which is composed of twenty-one members is elected by the shareholders. The Committee is formed in a way representing every side of the economic life of the country. The Managing Board includes fourteen members, *viz.*, President, Vice-President and others elected by the General Council. The President holds office for four years and his election must be confirmed by the President of the Reich. The Vice-President and twelve Directors are nominated by the Reich and elected by the General Council *for twelve years.* The Directors exercise the governing powers, frame the exchange, advance and discount policy of the Bank. The General Council consists of fourteen members, whose number has now been reduced to ten under the Young Plan. The members of the Council hold office for three years.

The Bank now possesses the monopoly right of note-issue. Under the law of 1924, the Reichs Bank must have to maintain a reserve of at least 40% in gold and foreign currency. Of this 30% of the note-issue must be held in gold. The reserve in foreign currency may include both notes and foreign bills maturing within fourteen days and payable at a first-class bank in a large money-market centre. The remaining 60% of the note-issue must be secured by discounted bills. In exceptional circumstances the reserve for note-issue may be allowed to fall below 40%, subject to the unanimous approval of the General Council. If the cover falls below 40% for more than a week, the following tax is payable on the difference between the actual cover and the statutory figure:

If the cover be between 37 & 40%—Tax payable per annum 3%
If the cover be between 35 & 37%—Tax payable per annum 5%
If the cover be between 33⅓ & 35%—Tax payable per annum 8%

If the cover be lower than 33⅓%, the tax is 8% *p.a.* plus 1% for every 1% the cover falls below 33⅓%.

In such a case the official discount rate must be at least 5% and the rate must be increased by one-third of the tax on the excess issue.

EXAMPLE:

Cover for Note-Issue	Tax	Minimum	Plus	New Minimum Rate
37%	3%	5%	3/3rds	6%
35%	5%	5%	5/3rds	$6\frac{2}{3}$%
$33\frac{1}{3}$%	8%	5%	8/3rds	$7\frac{2}{3}$%

But the above provision has been suspended by the amendment passed in 1933. The General Council and the Board can empower the Bank to let the metallic reserve fall below the legal minimum.

Under the law of 1924 the Reichs Bank is, in addition, to keep a reserve of 40% of the liquid assets against its deposits. These reserves may be built up out of cash, money at call, cheque on their banks or commercial bills maturing within 30 days.

The Bank is called upon to control the discount rate, determine the operations by Golddiskont-Bank, ration credit and to take direct action against banks. The discount policy was forged for the purpose of regulating the volume of credit, and preserving the external stability of the German currency. The policy had to undergo a thorough change since the banking crisis of 1931 in Germany, which led to the freezing of foreign balances, rigid restriction of exchange, etc. Now the discount policy is inspired more by domestic considerations.

During easy monetary conditions the Reichs Bank urges the Golddiskont-Bank to take off the surplus funds from the market and directs them to capital market in order to remove the discrepancy between the short-term and long-term money-rates.

Credit was rationed by the Reichs Bank in 1924-25, in the spring of 1929 and again in July 1931 and direct action was taken to check the boom in the stock exchange in May 1927. The President of the Bank, in a way, compelled the German Banks to curtail commitments against stock exchange securities.

The central banking authorities combined variations in cash reserve requirements with open market operations. In August 1957 it was announced that effective from December 1, export drafts (*i.e.*, bills drawn by German exporters on foreign customers but not accepted by the latter) would be altogether excluded from the rediscounting ceilings as one of the steps to counter the continuing heavy trade and payments surpluses. Since 1951 banks are required to observe minimum ratios of capital and surplus to total

assets or to specific categories of assets. They are to adjust their assets and liability structures by applying a series of minimum ratios—of capital to short-term credits and to acceptance credits, of current and acceptance credits to deposits and capital, and of liquid assets to deposits.

GERMAN BANKING SYSTEM

Germany was overtaken by a banking crisis in the year 1931. To avert that crisis the Government had to intervene by guaranteeing the repayment of the obligations of certain banks and bringing about the amalgamations of some of them. The crisis revealed the necessity for a thorough reconstruction of the banking structure. Accordingly in the same year a State Commissioner for banking was appointed as the Executive Officer of the Banking Committee. The Commissioner was to keep watch over the banking and credit situation of the country, and was armed with certain powers of control over the banking system. These powers were to be exercised only over private credit business ; the Reichs Bank, the Golddiskont Bank, four private note-issuing banks and some public banks were excluded from the purview of control.

With the rise of national socialists to power a Commissioner of Banking Enquiry was appointed in 1933 to inquire what functions should be given to the German banking system in order that German socialism may become a reality. On the basis of the recommendations of the said Commission the Banking Act was passed on 5th December, 1934. The Act regulates all banks with the exception of the Reichs Bank, the Golddiskont Bank, the Post-Office and certain other institutions of a special character and provides for the exercise of control through a supervisory Board and a Banking Commissioner. *Cash reserves* must be fixed by the Supervisory Board at a certain proportion to deposit-liabilities and may in no case exceed 10%. Besides the cash reserves, the Supervisory Board has the authority to fix the proportion of secondary reserves, which are normally composed of commercial bills with maturity of ninety days and must not exceed 30% of the deposit-liabilities. To prevent the immobilisation of funds, the Act restricts speculative investments and holdings of real estate.

Permanent participation in real estate must not exceed the capital and reserves of a bank. The ratio of capital to net liabilities must not exceed 20%. The Supervisory Board fixes the maximum advance that is permissible to a single borrower. Credit institutions with working capital RM 500,000 are not authorised to advance more than 10% to a single borrower and the smaller institutions 15%. The Banking Commissioner may inform the banks concerned when a borrower has obtained large credits from different credit institutions. The Banking Commissioner reserves the right to exempt certain credit institutions from the obligation of observing the various liquidity and credit ratios. The Banking Commissioner looks after the banking interests of the country by fixing interest rate and scales of commission, by controlling competition through restriction of opening of branches without prior permission and by the regulation of the cheque and Giro system.

German Banking in the Occupied Western Zones

The reorganisation of the Western German banking system, in progress since the end of the last war, is now entering a new phase. The present structure is the result of decisions taken by the allied authorities, particularly those of the U.S.A., and its resemblance to the institutions of that country is thus very marked. It is nevertheless obvious that recent developments, particularly with respect to the centralisation of credit control, have run counter to the intentions of the American framers of the laws of 1947 and 1949 which decentralised central as well as commercial banking.

Political developments in the Western Zones, leading to the creation of the Federal German Republic, are now beginning to affect the legal and organisational structure of post-war banking. Future changes in the system have become the responsibility of the Federal German Government with, of course, an allied right to veto undesirable decisions—and the present position is thus of interest only as a point of departure.

The Control of Monetary Policy

The note-issuing monopoly and the control over quantity and price of credit are at present in the hands of the Bank deutscher

Laender (B.d.L.). It has the power to vary minimum reserve requirements, fix discount rates, conduct open market operations, and in general lay down regulations determining the credit policy of all Land Central Banks (L.C.B.). It must consult with and take directions from the Allied Bank Commission (A.B.C.), a tripartite body consisting of the U.S.A., British and French elements. It has been the policy of the A.B.C. to allow the B.d.L. more and more scope and to wean it gradually from dependence on Allied directives. With the establishment of the Federal German Republic in 1949 it became necessary to provide for the eventual creation of a Federal Central Bank, and Article 88 of the basic law establishing the new state provides for the setting up of such a bank (Bundesbank). It is, of course, clear that the B.d.L. is destined to become the Bundesbank and the main problem involved is how far the new statute to be presented to the Federal Parliament (Bundestag) shall allow the government to direct the policy of the Bundesbank.

The technique by which the Government attempts to achieve control over banking policy is, of course, a minor matter. The position is complicated in Germany, because of the existing split in the responsibility for economic policy between the Ministry of Finance and the Ministry of Economics. Government responsibility for monetary policy is inevitable and desirable.

The Structure of the Commercial Banks

The present organisation of commercial banking in the Federal Republic is largely the result of the decentralising zeal of the U.S. Control Authorities, who managed, after some opposition, to get the other members of Allied Military Government to accept their proposals. The law covering the decentralisation of banks provides that no bank shall maintain branches outside the Land in which its head office is situated, and prohibits control of banks by an institution (except, of course, the B.d.L.) outside the Land in which they operate. Bank supervision has been made the responsibility of the Land authorities. Custodians were appointed in the case of the former large branch banks to take over the functions of the shareholders—they are, however, not subject to any sort of control by the shareholders. This law was intended to

provide only an interim solution until "the financial and economic structure was finaly determined".

The problems which any reorganisation of the commercial banks in Western Germany will have to solve can be split into three sections covering the legal problems, the problem of banking capital, and the problems of commercial banking operations.

1. *The legal problems.* Whatever the new organisation adopts, the pre-war branch banks will have to be finally dissolved, and their shareholders compensated with shares in the new corporations created.

2. *The problem of banking capital.* The Currency Reform reduced considerably the proportion of total liabilities represented by the bank's own resources. Under the Conversion Law the banks were to show in their new accounts as their own resources either 10 per cent. of their nominal capital or 7½ per cent. of their liabilities (less capital and reserves, of course). It is not the bank's capital, but its liquid and potentially liquid resources which safeguard its creditors. Thus in September 1950, 254 Credit Banks reporting to the Central Banking System had 22 per cent. of their outside liabilities covered by liquid assets and government securities.

3. *The problems of commercial banking operations.* The decentralisation of banking in Germany has reversed the normal development observable in every country in which legal restrictions have not impeded integration. The new difficulties arising are therefore exactly those which are overcome by integration. They can be divided into the following sections:

(*a*) Severe regional restriction of banking operations makes a diversification of risks very difficult. This is obviously so where there exists a geographic pattern of distribution of industry. The concentration of industry in certain parts of Germany, *e.g.*, coal and steel in the Ruhr, gives this point some—though not overwhelming—importance. It would, of course, be possible to overcome this difficulty by the growth of financial centres and bill financing, but particularly in the circumstances of present-day Germany direct bank loans must be regarded as the most important means of business finance.

(*b*) The total resources of the successor banks are insufficient

to allow any one bank to grant large credits. This applies especially if we remember that German banks have always considered as one of their main tasks the provision of "interim finance", *i.e.*, they have acted as issue houses and underwriters. Long-term capital has been provided in the first instance by the banks, who later issued securities of the firms concerned to provide funds for repayment of the loan. The banks also undertook to support these securities on the Stock Exchange. Again, a solution of this problem is possible without reintegration. Several banks could co-operate in the granting of large credits, and new specialist institutions could take over the task of issue and support of securities.

(*c*) Differences in the economic structure of the various Laender must lead to the appearance of surplus and deficit areas seasonally as well as structurally. Integrated branch banks will directly and automatically provide the required mobility of funds through administrative action at the head office. A unit banking system can obtain this mobility through the use of the services of a bill market, the correspondent system, or the rediscounting facilities at the Central Bank. In Germany to-day the bill market is almost non-existent and would only cover that part of bank finance which can be covered by bills of exchange. The correspondent system, though widely used, has not yet sufficiently developed to act as an equilibrating mechanism so that this task must be fulfilled largely by the Central Bank. If we take loans from the B.d.L. to the L.C.B.'s as a rough indication of the differences between surplus and deficit areas, we see that in October 1950 these loans varied from 0 per cent. of the total of the liabilities of L.C.B. of Bremen to 55.5 per cent. in the case of Schleswig-Holstein. While there is no doubt that the mobilising function can be fulfilled in this way, it involves extra costs and uncertainties for the individual banks.

(*d*) Probably the most important argument against a continuation of the present organisation of commercial banking in Germany is based on a consideration of the costs involved. The ratio of overhead costs to the volume of

business transacted tends to fall with the increasing business volume. This can be attributed mainly to the fact that certain departments, indispensable to an efficient bank, can serve a wide area without an increase in costs. Indeed, in a system of unit banking the cost of certain operations, *e.g.*, the maintenance of branches abroad, may be prohibitive for any one bank. Excessive decentralisation implies therefore an uneconomic use of resources by the banking system.

The abandonment of the Morgenthau-Bernstein plan and the deviation from the Potsdam agreement mean that decentralisation of banking is no longer a policy consistent with the political structure of Western Germany. The U.S. authorities have recently expressed their willingness to allow an enlargement of banking regions, and the British are known to have opposed decentralisation from the start. There is thus no *a priori* reason against the re-establishment of large branch banks operating over the whole area of the Federal Republic, but since a large section of American official opinion is still opposed to this course, a compromise solution has been proposed and will probably be made the basis of legislation in the near future.

The proposed plan involves the creation of three banking regions with freedom for banks to operate over the whole of any one region ; these are:

A northern Region, including Hamburg, Bremen, Schleswig-Holstein, Niedrsachsen.

A western Region, including Nordrhein-Westfalen, the districts of Trier and Koblenz.

A southern Region, including Hessen, Wuerttembergbaden, Bavaria, Baden, Wuerttemberg-Hohenzollern, the remainder of Rheinland-Pfalz.

THE CENTRAL BANKING SYSTEM OF WEST GERMANY

The structure and organisational pattern of the Central Banking system of West Germany differ from those of similar institutions in other countries. In line with the political structure

of West Germany its central banking system is federal in character. But it is not a copy of the American system. There are nine Land Central Banks on a regional level, with the Bank deutscher Laender at the head of this regional sub-structure. The management of the Bank deutscher Laender vests in two distinct bodies: (*a*) the Board of Directors consisting of a President, the Presidents of the 9 Land Central Banks and the President of the Board of Managers and (*b*) the Board of Managers consisting of its President and 7 more members. The Presidents of the Board of Directors and the Board of Managers are elected by the 9 Presidents of Land Central Banks. Thus, the authority of the central institution forms two distinct set-ups, the Board of Directors representing the policy-making organ which in its composition reflects the pattern of the sub-structure and the Board of Managers assuming responsibility for the execution of the decisions of the Board of Directors.

The Land Central Banks, like the Federal Reserve Banks of the U.S.A., have their own demarcated areas of operation within which they assume the tasks of 'bankers' banks' and exercise the functions of banks of issue. The Bank deutscher Laender, on the other hand, does not normally enter into dealings with the banks outside the system but maintains internal financing relations with the Land Central Banks, by granting them rediscounting facilities and keeping their cash reserves. The cash transactions of the Federal Government and credits to the Federal Government are, however, directly handled by the Bank deutscher Laender which is also the sole controller and ultimate reservoir of all foreign exchange.

This decentralised two-level system of credit and currency management has come in for a great deal of criticism since its inception in 1948. But eight years of successful operations have proved the efficiency of the system. The Land Central Banks, by their legal independence and participation in the composition of the policy-making body, tend to curb the growth of any overpowering central influence. On the other hand, the Land Central Banks, though legally independent, are functionally interdependent and together with the Bank deutscher Laender, constitute one organisational unit. Thus, the system combines the good points of both the centralised and decentralised systems. How far

it is able to serve the needs and to withstand the stresses of a rapidly expanding economy of a war-ravaged country, will be watched with interest.

BANKING SYSTEM OF SOVIET RUSSIA

Banks in Soviet Russia were nationalised by a decree of the Government on the 27th December, 1917, for a proper reorganisation of the national economy. Banking was thus declared to be a state monopoly and all private joint-stock banks and other banking institutions of the capitalist regime were merged in the State Bank, to which their assets and liabilities were all transferred. After the nationalisation of the private commercial banks the land banks, which were then engaged in the purchase and sale of land, were next liquidated, as their existence was considered to be unnecessary due to the state-ownership of land.

Planned socialist economy provides for a strict division of functions among the different banks in the U.S.S.R. The State Bank is the agency for short-term financing of the national economy. The industrial, trade, agricultural banks and the chain of municipal banks specialise in granting long-term credits and in the financing of capital investments in various branches of national economy. The State Bank is the biggest institution of its type in U.S.S.R. and has more than 4,000 branches in different republics, areas, regions and districts. All cash funds of Soviet enterprises are kept in the State Bank, which virtually occupies the position of a treasurer of nation's economy. It also acts as the country's clearing house setting the accounts between all socialist enterprises and institutions. The Bank issues short-term loans for meeting the requirements of industrial and trade organisations. The budget-revenue, which mostly exceeds expenditures, contributes separately to the resources of the State Bank. As the country's sole treasurer and the dispenser of short-term credits, the State Bank regulates currency circulation and is the Central Bank of issue in the U.S.S.R. The State Bank handles foreign trade accounts and foreign payments.

Long-term credit banks finance specially the projects of capital construction, plans for industrialisation and schemes for increasing output. The national economic plan sets out the cons-

truction projects, the costs involved, the building schedules, defines the sources of materials and finance for carrying out the construction programme. All funds appropriated for capital construction are mobilised through the channels of these long-term credit banks, which employ them for financing state construction, extending loans to farms and co-operative organisations. The agricultural banks grant credits to collective farms to develop agricultural economy and carry out projects calculated to raise yield, and execute irrigation and drainage schemes.

The Soviet credit economy is governed by this principle that each economic organisation pays its way. Each enterprise receives from the State both initial and working capital. The elimination of all forms of credit save and except direct bank-credit, enables the state to control, through the instrumentality of the banks, the activities of the economic enterprises and organisations. With each enterprise having its own working capital, bank credit may be used only for certain defined purposes. Thus bank credits are used for meeting expenditures caused by seasonal production, processes or seasonal accumulation of goods or supplies and also to cover the cost of goods in transit or for the period the accounts between the buyer and the seller are settled. In this way bank credit plays a unique role in Soviet national economy and constitutes 40% of the working capital of the country as a whole. In July, 1933 the amount of bank credit in the U.S.S.R. stood at 17,000 million roubles and rose to 48,000 million roubles on January 1, 1938. During three and a half years of the Third Five-year Plan they increased by another one-third more. During the World War II, the credit institutions in the U.S.S.R. assisted in mobilising the stocks of goods in various branches of national economy and at different stages of production process and helped in the redistribution of these stocks giving priority to heavy industries and war production. It will be relevant to quote here the observations of Lenin on the socialist credit system:

> "Without the big banks socialism would be impossible of achievement. The big banks constitute that state-apparatus which we need for the achievement of socialism, and which we shall take ready-made from capitalism ; our problem here is only to lop away that which capitalistically mutilates this splendid apparatus and to make it still bigger, still more

democratic, still more all-embracing. Quantity will be transformed into quality. A single huge state bank with branches in every rural area and rural factory will be nine-tenths of the socialist apparatus. That will be general state bookkeeping, general state accounting of production and distribution of goods, something in the nature, so to speak, of a skeleton of a socialist economy."

BANKING SYSTEM OF AUSTRALIA

The Commonwealth Bank of Australia was the Central Bank of that country. It commenced operations with a savings bank department in July, 1912 and undertook other general banking operations in January, 1913. In 1939 the Bank was called upon to discharge some special responsibilities during the stress and strain of the World War II. The general functions of the Bank as enunciated in the Commonwealth Bank Act, 1945, included the duty of pursuing a correct monetary and banking policy calculated to serve the best interest of the country and of exercising its powers in such a manner as in the opinion of the Bank would contribute to

(a) the stability of the currency of Australia,
(b) the maintenance of full employment in Australia,
(c) the economic prosperity and welfare of the people.

By virtue of the aforesaid Act, 1945, the Bank was empowered to control the liquidity, the advance policy and the interest rates of the Australian banks in general, and to mobilise the foreign currency and the gold resources of the country. It was also required to safeguard the interests of all depositors of the Australian banks against any loss.

In addition to its usual central banking functions, the Bank maintained a number of departments, each of which has its own separate accounts. These departments included the Note-Issue Department, the General Banking Division, the Rural Credit Department, the Mortgage Bank Department and the Industrial Finance Department. Although separately incorporated, the Commonwealth savings bank is under the management of the Governor of Commonwealth Bank. The Bank carried on its business through its 282 branches, 52 savings bank branches, 3,106

post office agencies and 836 other agencies. Half the net profits of the central banking business, the general banking division, and the Commonwealth savings banks was contributed to the National Debt Sinking Fund. Except for a payment of £150,000/- per annum to the mortgage bank department until the capital of that department had increased to £4,000,000 the net profits of the note-issue department were added to the consolidated revenue of the Commonwealth. Of the net profits of the rural credits department, one-half was transferred to the rural credits department fund, which was utilised for the promotion of research-work and other activities designed to assist primary production.

The System of Special Accounts

Under this system, the trading banks are required to transfer a very large part of their assets to a special account kept at the Commonwealth Bank. The amount of these deposits to be transferred is determined by the Commonwealth Bank which pays some interest to the banks. The funds kept in the 'Special Accounts' are a sort of time deposits without any fixed date of maturity withdrawable not on the demand of the depositor bank but at the option of the depositee bank. The system has been compared to that of the T.D.R. of England by a number of writers. There are, of course, important similarities between this system of T.D.R. and that of the Special Accounts. Both are a sort of forced loan on which banks receive some interest. T.D.R.'s have dates of maturity when they will be repaid though the actual repayment depended on the demands of the Treasury. The deposits in the special account may also be withdrawn by the banks though this will depend on the consent of the Commonwealth Bank. T.D.R.'s are rediscountable at the Bank of England though no clearing banker would ever think of doing so. The deposits in the special account leave no tangible instrument that may be discounted at the Central Bank.

In Australia the Commonwealth Bank has taken up almost all the cash balances of the banks above 7 to 8% and has been paying interest on the whole of this amount. Under this system the changes in the cash balances which each bank is required to keep at the Commonwealth Bank do not apply uniformly to all

banks. The ratio has varied differently for different banks. The trading banks were called upon to make the deposit in the special accounts from December, 1941 and the deposits aggregated £7.8 million. In 1943 the deposits in the special accounts varied between £102 million and £103.3 million and rose to £182.8 million in 1944. The purpose was to immobilise the surplus funds in the hands of banks which would have otherwise intensified the inflationary pressure. It is the normal policy of the Bank to provide for the growing requirements of the country or finance by releases from the special accounts according as circumstances demand on a scale sufficient to support an appropriate level of bank investments. There is flexibility in the use of this method in relation to each bank. The percentage of deposits which each trading bank has been required to keep in the special account has not only been different for each bank but has also not been the same in all the years even in the case of a particular bank. But there is no evidence of any complaint against this discriminatory practice adopted by the Commonwealth Bank. The deposits in the special accounts were regarded by the trading banks as part of their liquid assets and as a large percentage of these assets came to be frozen in the special accounts, banks considered themselves free to lower the amount of their cash balances. The system was instituted in 1941 in order to prevent the trading banks from making undue profits out of the national war finance and to enable the Commonwealth Bank to exercise control over the rate of creation of credit. Much of the success of the system in Australia is due to the small number of banks operating in that country and to the high sense of co-operation shown by them. But there is a danger "that the very sharpening of this instrument may tend to make it more difficult in operation".

According to the annual report of the Bank, the Rural Credits Department made advances totalling £252 million in the course of the year ending June, 1950. In addition it granted advances totalling £54.2 million against shipping documents for foodstuffs exported under contract to the British Food Ministry. The major portion of these funds has been obtained from the General Banking Division. The General Banking Division grants loans to all types of borrowers including primary producers against the mortgage of an estate or interest in land by the borrower. But

the Rural Credits Department grants loans only upon the security of primary produce placed under the legal control of the bank and upon such other securities associated with the production or marketing of primary produce as the Bank thinks fit. The Commonwealth Bank of Australia had up to June, 1950 invested the aggregate sum of about £31 million in long-term loans (£21.97 million in the Industrial Finance Department, £4.14 million in the Mortgage Bank Department and a total of £4.9 million approved during the year on account of housing loans). The total resources of the Bank in all Departments including the Savings Bank amounted to £1581.7 million. The major portion of funds invested in the Mortgage Bank Department and the Industrial Finance Department had possibly come from the Savings Bank.

The Commonwealth Bank of Australia has been reconstituted as the Reserve Bank of Australia under the Reserve Bank Act 1959 which has come into force on the 1st January, 1960. The above Act replaces the earlier Commonwealth Bank Act, 1945, 1948, 1951 and 1953. The Reserve Bank Board consists of the Governor, the Deputy Governor, the Secretary to the Department of the Treasury, seven other members appointed by the Governor-General. The reconstituted Reserve Bank now exclusively discharges central banking functions and has shed other non-central banking functions.

Under the above Act, the Reserve Bank has to maintain a Rural Credits Department and keep its accounts separate and distinct from the other accounts and transactions of the Bank. The Rural Credit Department shall have a reserve fund to be called the Rural Credits Department Reserve Fund as also another fund called the Rural Credits Department Fund. The accounts and records of financial transactions of the Bank are audited by the Auditor-General.

The Commonwealth Banking Corporation and Others

The Commonwealth Banks Act, 1959 provides for the establishment of the Commonwealth Banking Corporation and makes provisions for the conduct of the business of the Commonwealth Trading Bank of Australia, the Commonwealth Savings

Bank of Australia and the Commonwealth Development Bank of Australia.

The Commonwealth Banking Corporation shall make available to the Trading Bank, the Savings Bank and the Development Bank such officers and employees are necessary for efficiency conducting the business of each of these banks. There shall be a Commonwealth Banking Corporation Board which will have power to determine the policy of the Trading Bank, of the Savings Bank and of the Development Bank and to control the officers of the Corporation and of each of those banks.

The Commonwealth Banking Corporation Board shall consist of the Managing Director, the Deputy Managing Director, the Secretary to the Department of the Treasury and eight members appointed by the Governor-General.

The Commonwealth Trading Bank of Australia established under the Commonwealth Bank Act 1945-53 is preserved. The Trading Bank shall carry on general banking business. Its capital shall be the aggregate of the Trading Bank immediately before the commencement of this Act, the sum of two million pounds paid by the Reserve Bank to the Trading Bank on the commencement of this Act, etc. There shall be a General Manager of the Trading Bank who shall be appointed by the Governor-General on the recommendation of the Board. The Trading Bank shall pay to the Corporation an amount determined by the Board to be the proportion of the expenses of the Corporation attributable to the Trading Bank.

The continuity of the Commonwealth Savings Bank established before is preserved. The Savings Bank shall carry on the general business of a savings bank. The Savings Bank shall have a reserve fund which shall consist of the aggregate of—

(*a*) the amount standing to the credit of the Savings Bank Reserve Fund existing under the Commonwealth Bank Act 1945-53 immediately before the commencement of this Act and

(*b*) such other sums as are placed to the credit of the Fund.

There shall be a General Manager for the Savings Bank who shall be appointed by the Governor-General on the recommendation of the Board. The Savings Bank shall pay to the Corporation such expenses as attributable to its operations.

Loans may be made by the Trading Bank or the Savings Bank to building societies and to individuals for the erection or purchase of homes. The period of such loans shall not be less than for five years or more than thirty-five years.

The Commonwealth Development Bank has also been established. The functions of the Development Bank are—

(*a*) to provide finance for persons—

(*i*) for the purposes of primary production

(*ii*) for the establishment or development of industrial undertakings and

(*iii*) to provide advice and assistance for the efficient conduct of primary production or of industrial undertakings.

The Development Bank is also authorised to carry on banking business. The capital of the Development Bank shall be the aggregate of—

(*a*) the amount of the capital of the Mortgage Bank Department of the Commonwealth Bank of Australia immediately before the commencement of this Act ;

(*b*) the amount of the capital of the Industrial Finance Department of the Commonwealth Bank of Australia ;

(*c*) the amount of five million pounds which shall be paid by the Reserve Bank to the Development Bank ; and

(*d*) such other sums as are transferred from the Commonwealth Development Reserve Fund.

There shall be a General Manager of the Development Bank who shall be appointed by the Governor-General on the recommendation of the Board. The Development Bank shall pay to the Corporation such expenses as are attributable to it.

There are certain restrictions on its borrowings from the Reserve Bank of Australia which shall not exceed two million pounds. The Development Bank shall not also borrow moneys repayable in a currency other than Australian currency.

Private Trading Banks

There are 8 Australian, 3 Anglo-Australian, and 3 Overseas trading banks carrying on usual banking business in Australia. There exist three other banks, established by State Governments,

which also undertake normal banking operations, but address themselves particularly to the task of financing rural industries and home building. These banks were to keep with the Commonwealth Bank special deposits carrying interest at the rate of $1\frac{1}{2}\%$ p.a. under the National Security (Wartime Banking Control) Regulations as a safeguard against "secondary inflation". Maximum rates of interest on bank deposits and overdrafts were also fixed under the National Security (Economic Organisation) Regulations.

The affairs of these trading banks are subject to periodical inspection by the Auditor-General. For the protection of the depositors, the Commonwealth Bank is also authorised to inspect any bank, when necessary, and to assume control of the business of any bank that is unable to meet its obligations to depositors.

If any bank is convicted for any offence under the Act and fails to comply with a direction of the High Court to observe the provisions of the Act, the High Court may authorise the Commonwealth Bank to assume control of the business of that bank.

STATE BANK OF PAKISTAN

The State Bank of Pakistan was constituted under the State Bank of Pakistan Order, 1948 for the purposes of taking over as from the first day of July, 1948 the management of the currency from the Reserve Bank of India and carrying on the business of central banking in Pakistan. The Head Office of the bank is situated in Karachi and the capital of the Bank is Rs. 3 crores, divided into 300,000 shares of the nominal value of Rs. 100/- each which shall be fully paid up and of which not less than 51% shall be issued to the Pakistan Central Government. The balance of the share capital remaining after deducting the amount of the shares to be issued to the Central Government shall be offered for public subscriptions.

The general superintendence and direction of the affairs and business of the bank shall be entrusted to a Central Board of Directors which shall consist of the Governor, one or more Deputy Governor(s), if appointed, and nine Directors nominated or elected in accordance with the provisions of clause 9 of the Order. A

Local Board shall be constituted for each of the three areas and shall consist of four members elected from amongst themselves by the shareholders and not more than five members nominated by the Central Government.

The constitution of the Bank has been drawn up on the model of the Reserve Bank of India Act and the Bank carries on all such business which the Reserve Bank of India is authorised to transact. On and after the 1st of July, 1948 the Bank shall have the sole right to issue bank notes in Pakistan. The assets of Issue Department shall consist of gold coin, gold bullion, silver bullion, sterling securities, approved foreign exchange, rupee coin and rupee securities to such aggregate amount as is not less than the total of the liabilities of the Issue Department. Of the total amount of the assets not less than 30% shall consist of gold coin, gold bullion, silver bullion, sterling securities or approved foreign exchange. The remainder of the assets shall be held in rupee coin, rupee securities of any maturity and such bills of exchange and promissory notes payable in Pakistan as are eligible for purchase by the Bank under para (*a*) or para (*b*) of sub-clause (2) of clause 13. Of the gold coin and gold or silver bullion held as assets not less than 17/20 shall be held in Pakistan.

A scheduled bank in Pakistan is required to maintain with the bank balances aggregating 5% of its demand liabilities and 2% of its time liabilities.

The Banking Control Department has been constituted to perform all functions in relation to the scheduled and non-scheduled banks operating in Pakistan. During the year the State Bank decided to liquidate two banks in Western Pakistan for their continued failure to comply with the statutory requirements under the Banking Companies (Control) Act, 1958. It also decided to take into liquidation those non-scheduled banks in East Pakistan which similarly failed to fulfil the statutory requirements of the said Act.

In February, 1951 India recognised the par value of the Pakistani rupee. Following the acceptance by India of the par value of Pakistani Rupee the following rates were laid down for dealings in respective currencies:

(i) State Bank of Pakistan buying rate Rs. 144-0-9 India, for Rs. 100/- Pakistan.

(ii) State Bank of Pakistan selling rate Rs. 143-13-3 India, for Rs. 100/- Pakistan.
(iii) Reserve Bank of India buying rate Rs. 69-8-3 Pakistan, for Rs. 100/- India.
(iv) Reserve Bank of India selling rate Rs. 69-6-6 Pakistan, for Rs. 100/- India.

The year 1950-1951 was a year of steady progress for the State Bank. The nucleus of a Research Organisation was established. Statistics were mechanised and Balance of Payments Statements began to be prepared. Special measures were taken to make the National Bank of Pakistan an important factor in commercial banking. The initial period of rapid expansion having passed, the Bank has entered the stage where improvement of services and the consolidation of the structure must be its chief pre-occupation.

The principal function of the State Bank as a Central Bank is to regulate currency and credit in the best interests of the country so that monetary stability should be ensured and the most favourable conditions maintained for promotion of economic activity on healthy lines. In the first instance, the primary instruments to carry out such a policy are open-market operations and discount policy. The Bank is empowered to purchase and sell Government securities of any maturity ; to deal in specified securities of local authorities ; and to purchase, sell, and discount certain types of bills and promissory notes of a maturity not more than 90 days, except that where such instruments relate to the financing of seasonable agricultural operations, for the marketing of crops, maturities of up to 9 months might be accepted. The State Bank is authorised to extend to local authorities, scheduled banks, or provincial co-operative banks, loans and advances against specified types of securities, either repayable on demand, or on the expiration of a fixed period not exceeding 30 days. The Bank is further authorised to discount or rediscount certain types of bills or other commercial paper. The Bank is to assure the continued functioning of banking services and the readiness of banks to meet their legal obligations and a special department of the Bank was set up to take all practicable measures to ensure the protection of interests of the Pakistani depositors. The Bank is to act as banker to both the Central and Provincial Governments in Pakistan and to make short-term advances from time to time

to cover Government expenditure in excess of revenue. It is also to manage the public debt and to arrange for the issue and service of loans.

Profits arising from its business are to be divided between the shareholders and the Government. After provision for all bad and doubtful debts, depreciation on assets, etc. a cumulative dividend at the rate of 4% per annum is to be paid by the Bank to its shareholders and the surplus, if any, to the Government of Pakistan. In return, the Bank is exempted from income-tax.

As a basis for open-market operations, an attempt was made by it to develop a securities market, but the Stock Exchange in Karachi remained very restricted and the supply of investment scrip was limited. The State Bank announced its intention to give reasonable support to the market and funds were also provided in this way during the periods of financial stringency. In all cases dealings took place through brokers. The State Bank has been prompted on occasions to buy securities from the banks during the busy season for the purpose of putting them in funds and to sell securities to them when their cash balances rise. The Bank informs its brokers that it is prepared to buy or sell and leaves it to the rest of the market to make use of the facilities offered. Apart from the effects on bank liquidity, this has provided more or less consistent demand for such securities as are available, and prices have been stable.

The State Bank's discount rate provided the basis of the market structure. The discount rate on *hundis* varies a great deal and depends on the standing of the customer. The seasonal character of the business done is most obviously reflected in the rate on inter-bank call loans. In Karachi there is a quite well-developed market. Further in the system which is still relatively immature, the State Bank has felt the need for a more direct control over the commercial banks than can be provided by resorting to the traditional weapons. In addition, the Government felt acutely its lack of complete independence in the banking field as a result of the foreign ownership of most of the banks operating in Pakistan. Of 35 leading banks doing business in Pakistan at the time of the partition, only two had their Head Offices there and the policies and activities of the majority of the banks were directed from outside the country. As stated before, the scheduled

banks in Pakistan are required to maintain 5% of their demand liabilities and 2% of their time liabilities with the State-Bank. Furthermore, by the amendment to the original order, the Bank reserves the right to increase the reserve requirements by notification in the event of its becoming necessary to limit credit facilities in order to safeguard the economy.

Initially, the banking companies in Pakistan were required to hold in Pakistan assets amounting to 75% of their demand and time liabilities to depositors in Pakistan. Subsequently this ratio was raised to 85%. Moreover, the prescribed percentage must now be maintained throughout the year instead of at the close of each quarter as previously. Under the Banking Companies Control Act, 1948, as amended, the State Bank has also been given general powers to call for information from the other banks and to discourage or even to prohibit banks from undertaking particular types of transactions. The State Bank, in the event of emergency, might now assist both scheduled and non-scheduled banks directly by offering either loan or discount facilities.

As a part of the system of bank control, the State Bank is also empowered, with the previous sanction of the Central Government, to inspect banks. Furthermore, in terms of the Banking Companies (Restriction of Branches) Act, 1946, as amended, banks must apply for a licence from the State Bank for the opening of new branches or for changing location of the existing offices.

In order to study the problems connected with agricultural credit, a separate section has been set up in the Banking Control Department.

COMMERCIAL BANKS

The structure of commercial banking in Pakistan owes much to the inheritance of institutions developed in undivided India. In Pakistan commercial banking proper (apart from the National Bank of Pakistan which is dealt with separately) may be conveniently divided into three groups: exchange banks, Indian banks and Pakistani banks. The leading Pakistani banks are the Habib Bank Ltd., the Muslim Commercial Bank Ltd., the Bank of Bahawalpur and the Australasia Bank Ltd. The oldest Pakistani bank is the Central Exchange Bank founded in 1926.

Exchange banks naturally do the bulk of the work in foreign exchange but the other joint-stock banks are also developing an interest in this field.

Industrial Finance

An Industrial Finance Corporation has been established under the Pakistan Industrial Finance Corporation Act, 1949 to provide medium-term finance to industries which would otherwise experience difficulties in raising the necessary funds. Its authorised capital was fixed at Rs. (P)3 crores of which the Pakistan Government held 61 per cent. The shares of the Corporation and a minimum annual dividend are guaranteed by the Central Government. The Corporation has built up a reserve fund but until this reaches the same figure as its paid-up capital [at present Rs. (P)2 crores] the rate of dividend has been restricted to $2\frac{3}{4}\%$ per annum. The borrowing powers of the Corporation are limited to 5 times the amount of its paid-up capital and reserve fund. Within these limits and with the prior approval of the Central Government, it may issue and sell bonds and debentures for the purpose of increasing its working capital at such rates as are approved by the Government which shall guarantee interest on and repayment of such liabilities. In addition, the Corporation may accept deposits on terms and conditions and to the extent approved by the Central Government.

During the first two years of operation, the Corporation only granted direct loans but recently it has agreed to underwrite the issue of shares and debentures. A wide range of industries has been assisted and those which profited most included textiles, sugar, printing, food processing, and electricity.

THE NATIONAL BANK OF PAKISTAN

The National Bank of Pakistan was constituted under the National Bank of Pakistan Ordinance No. XIX of 1949 promulgated by the Governor-General on the 8th November, 1949. The Pakistan Government originally intended to establish the bank under an Act of the Dominion Legislature but in September, 1949

they decided to set it up immediately in view of the threatened crisis in the jute market in East Pakistan consequent on the devaluation of the Indian rupee. Accordingly the Ordinance constituting the bank was promulgated and the bank started functioning within a few days of its formation. Early in 1949, a private limited company under the name of the Promoters Co. Ltd. was formed with the object of promoting this Bank. The company ceased to function on the formation of the Bank and legal proceedings were started for winding it up. Under the transitional provisions of the Bank's Ordinance, the Bank was permitted only to undertake the business of financing jute, cotton and other agricultural commodities. In addition, the Bank was authorised to transact any other business with the prior approval of the Central Government.

The Bank has an authorised capital of Rs. 6 crores of which Rs. 2,30,22,400 have been issued and subscribed up to the 31st December, 1950 and the paid-up capital amounts to Rs. 57,55,600. For the present 50% of the value of each share will be called up and the balance shall not be called up except in the event and for the purpose of the Bank being wound up. The Central Government shall be a shareholder of the Bank and shall purchase at par not less than 25% of the shares issued by the Bank from time to time.

The general superintendence and direction of the affairs and business of the Bank shall be entrusted to the Central Board which shall consist of the following Directors, *viz.*,

(*a*) the Managing Director appointed by the Central Government under section 16 ;
(*b*) eight Directors selected in local or special local meetings by the shareholders ;
(*c*) three Directors appointed by the Central Government.

The President of the Central Board shall be appointed by the Central Government from amongst the Directors. A Local Board shall consist of the following members, *viz.*,

(*a*) The Managing Director or a Deputy Managing Director.
(*b*) One member appointed by the Central Board from amongst the Directors elected by the shareholders registered in the branch register of that area.

(*c*) Two members appointed by the Central Government from the area in which a Local Board is established.

(*d*) Two members elected in a local or special local meeting from amongst themselves by the shareholders registered in the branch register of that area.

The Managing Director shall be appointed by the Central Government on such terms and for such period not exceeding three years as it may fix at the time of appointment. The Bank is not authorised to transact the following types of business:—

(1) It shall not make any advance or loan—

(*a*) For a longer period than 12 months or

(*b*) upon the security of shares of the Bank or

(*c*) save in the case of the estate specified in clause (3) of section 25, upon mortgage or in any other manner upon the security of any immovable property or documents of title relating thereto.

(2) The Bank shall not discount or buy or advance or lend to any individual or partnership firm an amount exceeding in the whole at any one time such sum as may be prescribed.

(3) The Bank shall not discount or buy or advance or lend or open cash credits on the security of any negotiable instrument of any individual or partnership firm payable in the town or at the place where it is presented for discount, which does not carry on it the several responsibilities of at least two persons or firms unconnected with each other in general partnership.

CENTRAL BANK OF CEYLON

The Central Bank of Ceylon was constituted under the Monetary Law Act, No. 58 of 1949 to fulfil the following objects:

(*a*) the stabilization of domestic monetary values ;

(*b*) the preservation of the par value of the Ceylon rupee and the free use of the rupee for current international transactions ;

(*c*) the promotion and maintenance of a high level of production, employment, and real income in Ceylon ; and

(*d*) the encouragement and promotion of the full development of the productive resources of Ceylon.

THE MONETARY BOARD

(1) The Monetary Board of the Central Bank shall, in addition to determining the policies or measures authorised to be adopted or taken under this Act, be vested with the powers, duties, and functions of the Central Bank under this Act, and be generally responsible for the management, operations, and administration of the Bank.

(2) The Monetary Board shall consist of—

(*a*) the Governor of the Central Bank who shall be the Chairman of the Board ;

(*b*) the person holding office for the time being as a Permanent Secretary to the Ministry of Finance ; and

(*c*) a third member appointed by the Governor-General on the recommendation of the Prime Minister.

The term of office of the Governor, and of the person appointed under paragraph (*c*) of section 8 (2) (hereinafter referred to as the "appointed member"), shall, subject to the provisions of sub-section (2) of this section, be the period of six years commencing on the date of his appointment.

The Central Bank shall establish and maintain a Department of Economic Research which shall prepare data and conduct economic research, for the guidance of the Monetary Board and the Governor in formulating, implementing, and executing policies and measures and for the information of the public, in the subjects of money and banking and other economic subjects of general interest.

THE DEPARTMENT OF BANK SUPERVISION

For the purposes of the continuous supervision and periodical examination of all banking institutions in Ceylon, the Central Bank shall establish and maintain a Department of Bank Supervision.

The Director of Bank Supervision shall examine, or cause an Examiner of his Department to examine, the books and accounts of every commercial bank in Ceylon at least once in each examination period, and shall make such further examinations in respect of any specified bank whenever required so to do by the Governor.

Examination of the books and accounts of banking institutions other than commercial banks, or of any specified banking institutions, shall be made if directions in that behalf are given by the Monetary Board.

In any case where the Director of Bank Supervision is satisfied, after examination by himself or any Examiner of the affairs of any banking institution, or upon information received from the institution, that the institution is insolvent or is likely to become unable to meet the demands of its depositors, or that its continuance in business is likely to involve loss to its depositors or creditors, the Director shall make a report accordingly to the Governor for submission to the Monetary Board ; and if the Board, upon review of the facts and circumstances, is of opinion that action should be taken as hereinafter provided, the Board may make order directing the institution forthwith to suspend business in Ceylon and directing the Director to take charge of all books, records and assets of the institution and to take such measures as may be necessary to prevent the continuance of business by the institution.

In any case where an order is made, whether in pursuance of an application under section 30 or otherwise, for the winding-up of any banking institution, then, notwithstanding anything in any other written law, the Director of Bank Supervision shall be appointed to be the liquidator for the purposes of such winding-up.

The International Reserve of the Central Bank may include the following assets:

(*i*) gold ; and

(*ii*) assets in foreign currencies in the form of—

(*a*) documents and instruments of types customarily employed for the international transfer of funds ; or

(*b*) demand and time deposits in Central Banks, Treasuries, and commercial banks abroad ; or

(*c*) securities of foreign governments ; or

(*d*) foreign notes and coins.

REGULATION OF FOREIGN EXCHANGE OPERATIONS OF COMMERCIAL BANKS

The Monetary Board shall determine the minimum rate at which commercial banks may buy spot exchange and the maximum rate at which they may sell spot exchange. Where the Monetary Board has certified the legal parity of a currency in accordance with section 72, the maximum and minimum exchange rates established for such currency shall not differ from such parity by more than one per centum.

No commercial bank shall buy spot exchange at any rate below the minimum rate determined under sub-section (1) or sell spot exchange at any rate exceeding the maximum rate so determined ; and no commercial bank shall in respect of any purchase or sale of such exchange accept any commission or impose any charge of any description except telegraphic or other costs actually incurred in connection with such purchase or sale.

No commercial bank shall carry out any transaction in exchange, not being a spot transaction, at any rate which differs from the rate determined under sub-section (1) for a spot transaction—

(*a*) by a margin greater than is reasonable having regard to the additional costs, expenses or risks of the transaction ; or

(*b*) by such margin, if any, as may be prescribed in that behalf by the Monetary Board.

The Monetary Board may direct that proportion which the assets in Ceylon rupees or commercial banks in Ceylon bear to the liabilities in Ceylon rupees of such banks shall not be less than such proportion as the Monetary Board may prescribe, or may direct such banks to maintain a balanced position between their assets and liablities in any currency or currencies in which they operate. The Board shall allow to such banks a reasonable period of time in which to comply with any such direction.

Subject to the principles stated in the preceding section of this Act, the Central Bank may ordinarily transact with commercial banks and the Co-operative Federal Bank of Ceylon, Limited, credit operations of any description set out hereunder:

(*a*) *Commercial credits.*—The Central Bank may discount,

rediscount, buy, and sell bills, acceptances, promissory notes, and other credit instruments with maturities of not more than 180 days from the date of their discount, rediscount, or acquisition by the Central Bank and resulting from transaction related to—

(*i*) the importation, exportation, purchase, or sale of readily saleable goods and products, or their transportation within Ceylon ; or

(*ii*) the storage of non-perishable goods and products which are duly insured and deposited under conditions assuring their preservation in authorised bonded warehouses or in other places approved by the Monetary Board.

(*b*) *Production credits*.—The Central Bank may discount, rediscount, buy, and sell bills, acceptances, promissory notes, and other credit instruments having maturities of not more than 270 days from the date of their discount, rediscount, or acquisition by the Central Bank and resulting from transactions related to the production, manufacture, or processing of agricultural, animal, mineral, or industrial products.

(*c*) *Advances*.—The Central Bank may grant loans or advances for any fixed period not exceeding 180 days upon promissory notes secured by the pledge with the Bank of—

(*i*) gold coins or bullion ; or

(*ii*) negotiable Treasury bills, promissory notes, debentures, bonds, or other negotiable securities of the Government ; or

(*iii*) securities issued by the Central Bank itself or other credit instruments of banking institutions operating in Ceylon and approved by the Monetary Board ; or

(*iv*) credit instruments referred to in paragraph (*a*) of this sub-section ; or

(*v*) credit instruments referred to in paragraph (*b*) of this sub-section.

Notwithstanding anything in the preceding provisions of this paragraph, loans or advances secured by the pledge of any credit instrument referred to in paragraph (*b*) of this sub-section may be for a period not exceeding 270 days.

In special circumstances in which the Monetary Board considers it necessary to promote or facilitate lending operations or particular classes of such operations by banking institutions which makes loans upon mortgages, whether of movable or of immovable property, the Central Bank may grant loans or advances to any such institution against promissory notes given by such institution subject to and in accordance with the following conditions:—

(*a*) that the loan or advance is repayable within a period not exceeding one year ;

(*b*) that the repayment to the Central Bank of the loan or advance is secured by the assignment to the Bank by way of pledge—

 (*i*) of debts falling due for payment within the same period to the institution by its borrowers, and

 (*ii*) of the mortgages given as security for the payment of such debts to the institution ;

(*c*) that the borrowers from whom such debts are due to the institution are not in default or arrears ; and

(*d*) that the total amount of the loan or advance by the Central Bank must not exceed fifty per centum of the total amount of the debts which are so assigned to it.

In periods of emergency or of imminent financial panic which directly threatens monetary and banking stability, the Central Bank may grant to banking institutions, and may renew extraordinary loans or advances secured by any assets which are defined as acceptable for the purpose by the Monetary Board by unanimous decision.

A banking institution to which an extraordinary loan or advance is granted under sub-section (1) shall not, while the loan or advance is outstanding, expand the total volume of its loans and investments except with the prior approval of the Monetary Board.

The Central Bank shall Conduct Open-market Operations

The Monetary Board shall, in order to limit the volume of money created by the credit operations of the banking system, require commercial banks operating in Ceylon to maintain reserves

against their deposit liabilities, and shall for such purpose define the classes of deposit liabilities against which reserves shall be held.

The Central Bank shall provide facilities for clearance transactions among commercial banks operating in Ceylon.

The Monetary Board may from time to time by order prescribe the minimum ratios which the capital and surplus of commercial banks shall bear to the total volume of their assets or to any specified categories of such assets.

The Monetary Board may by order direct that letters of credit shall not be opened by commercial banks unless such letters are covered by minimum margins of such kind, amount, or proportion as may be prescribed by the Board ; different margins may be so prescribed for different classes of transactions to be financed by means of letters of credit.

The Monetary Board may from time to time make order—

(*a*) fixing the maximum rates of interest which commercial banks may pay upon various classes of deposits ; or

(*b*) fixing the maximum rates of interest which commercial banks may charge for different types of loans or other credit operations.

The decision of the Government of Ceylon to establish a Central Bank was a decision with far-reaching implications for the people of Ceylon. Good central banking is less good law than good practice. The Central Bank of Ceylon may make its influence felt more effectively through the development of day-to-day relations of confidence and understanding between itself and the various banking institutions than through the exercise of all the powers conferred upon it under this Act. Such influence is known as "moral suasion" and should be especially important in a small country where it should be possible to develop close relation between the Central Bank and each of the fairly limited number of banking institutions.

Experience of Central Banks in underdeveloped economies reveals that such banks need different and wider powers than those in developed economies. Traditional instruments of Central Bank action, like setting the discount rate or engaging in open-market operations, are often ineffective or inappropriate even in highly developed countries like Britain and the United States. In a country like Ceylon, with its very small capital market, such instru-

ments may be utterly useless. Special problems are also created where the great majority of the credit institutions are foreign owned.

In countries similar to Ceylon, Central Banks have had to devise new instruments of action. In this way have been developed such instruments as control of reserve requirements, interest rates, portfolio ceilings, capital-asset ratios, and letters of credit margins.

It is obvious that the resources of the Island cannot be fully developed unless credit is made more freely available. But a Central Bank cannot force a commercial bank to lend when it does not wish to lend. It is therefore advisable that in Ceylon the Central Bank should have authority to lend at certain times to credit institutions other than commercial banks and that it should have the authority to take measures to reduce some of the unusual risks of lending in Ceylon. For this reason it is recommended that the Central Bank have the authority to lend to mortgage lending institutions and also to the co-operative credit movement, whose sound development in the past indicates that it is a most promising means of making greater credit facilities available to the small farmer. In order to reduce risks of lending in Ceylon, the Central Bank should have the authority to act as the agent of the Government in such systems of loan insurance or loan guarantees as may be established in the future.

Like a number of other underdeveloped economies, the Ceylon economy is ordinarily dependent for its prosperity upon the ability to sell a few primary commodities in foreign markets at satisfactory prices. It is therefore peculiarly dependent upon economic conditions abroad, and is especially sensitive to the world business cycle. It would be a mistake to anticipate that the Central Bank will immediately be able to insulate the Ceylon economy against short-run fluctuations in the recepits of the major export industries on which the level of consumption in Ceylon primarily depends. The most that the Bank can do is to help alleviate some of the more serious effects of such fluctuations. In the long run, however, the Bank may be able to do a great deal towards strengthening the economy. By helping to direct the savings and credit resources of the nation, as well as foreign capital, into new agricultural development and new industries, it can stimulate a diversification of the economy which will make it more resilient and adaptable to changing economic conditions abroad.

PART II

CHAPTER VI

INDIAN MONEY MARKET

THE Indian money market is composed of the loosely knit units, which are not correlated to each other. Each unit, namely, the Imperial Bank of India (now the State Bank of India), the exchange banks, the joint-stock banks, the co-operative banks and the indigenous bankers, is self-contained in its respective sphere and often follows independent policies which might clash and weaken the monetary structure. The joint-stock banks are jealous of the privileged position of the Imperial Bank of India (now the State Bank of India). The exchange banks hold an enviable position in the Indian money market being the sole agencies for financing India's foreign trade and are serious competitors with Indian banks in the field of inland trade as well. The relation between co-operative banks and other joint-stock banks is not continuous, nor is it so regular as it should be. The indigenous bankers are so wide apart from modernised banking institutions and fall still to-day outside the ambit of centralised banking control. Naturally the Indian money market cannot help being divided into so many isolated segments, instead of being a compact unit. It is expected that the Reserve Bank of India will, in course of time, be able to bring about a co-ordination between the different units and integrate them into an organised money market.

As an inevitable result of the sectional organisation of the money market, there exist disparities in money-rates in different parts of India. The Central Banking Enquiry Committee observed this disparity as they say, "the fact that a call rate of ¾ per cent, a hundi rate of 3 per cent, a bank rate of 4 per cent, a Bombay Bazar rate for bills of small traders of 6¾% and a Calcutta Bazar rate for bills of small traders of 10% can exist simultaneously indicates an extraordinary sluggishness in the movement of credit between the various markets". The disparities between different money-rates cannot be levelled down all at once. The levelling process will take some time until the different sections are brought

together under the guiding influence of the Central Bank of the country, *i.e.*, the Reserve Bank of India.

Another disquieting feature of the Indian money market is the existence of seasonal monetary stringency. In our country the period covering November to June is a busy season due to movements of crops and the period from July to October slack. There arise wide fluctuations in money-rates during these two periods. The Reserve Bank of India can meet such a situation if it spreads more easily the available resources over the different parts of the country and the different seasons of the year. With the operation of the Reserve Bank of India it is expected that 'the supply of additional note currency against eligible commercial paper would be automatic'. With the introduction of the Bill Market Scheme by the Reserve Bank of India, this object appears to have been achieved.

A well-organised bill market is an essential condition for an efficient money market. In India the bill market is non-existent, as the bill habit is mostly undeveloped. There are other reasons for lack of bill habit. In the first place, the liquidity ratio of banks in India being comparatively high, Indian banks prefer to invest relatively more funds in Government securities to discounting of bills. Secondly, the defective forms of bazar hundis are hindrances to the development of a bill market. as from the forms it is not possible to distinguish whether the hundis are purely finance bills or genuine trade bills since they are not supported always by documents like sale contracts, invoices, documents of title to goods etc. Moreover hundis are various in forms and are governed by the diversity of practices. As a result, it is not always safe to purchase those instruments. Thirdly, the advantage of cash credit advances negatives the necessity for bill-discounting. If the bill market is developed, one of the weak spots in the money market will be obliterated and the credit structure will be more elastic and efficient. The following recommendations were made by the Central Banking Enquiry Committee for the promotion of a bill market in India:

The Reserve Bank of India should, without further delay, offer rediscounting facilities against approved bills and thus set the pace. Discount charges should be reduced to encourage the purchase of bills, and clearing houses for bills standardising uniform charge, should be set up in all provincial capitals. Licensed warehouses

should be built in adequate numbers in principal trade centres, so that documentary bills supported by warehouse certificates may take the place of accommodation bills and advances may be obtained against those warehouse receipts. In due course these warehouse receipts should be given the legal sanction of negotiability by the Government. Stamp duty on usance bills should be reduced to popularise the circulation of bills, according to the recommendation of the Reserve Bank, the Government of India reduced in 1940 stamp duty on bills to -/2/- per thousand. The Post Office should stock printed bill forms in English and Indian languages in parallel. Steps should be taken for the standardisation of the forms of hundis, if necessary, by legislation. Banks should take the initiative in accepting bills on behalf of their chosen customers, as bankers' acceptances will be more readily negotiable than ordinary trade bills. Attempts should further be made to encourage bill-broking as an integral part of indigenous bankers' business so that the indigenous bankers may, in course of time, discharge the functions of *discount houses*. The use of bills should be extended in the following directions:

(*a*) Agricultural paper should be created for advances to ryots for the growing of crops,

(*b*) the ryots, by becoming members of co-operative godown societies, should raise finance from the latter on the security of the produce by asking the latter to draw usance bills on themselves, *i.e.*, owners of produce,

(*c*) the Shroffs should finance the village brokers by drawing bills, which may be discounted with any bank,

(*d*) the movements of crops from the port town to the interior should be financed by the drawing of bills,

(*e*) Rupee Import Bills should be introduced in place of Sterling Import Bills for the financing of India's foreign trade. Bankers' acceptances should be promoted for financing the import trade.

A start may be given by encouraging acceptances on the part of banks of commercial bills drawn on their selected customers. Besides this, trade bills drawn against the supply of goods to Government department, railways, established commercial houses, public and semi-public institutions may be freely discounted in the market, if the authorities concerned take the pains of accept-

ing these bills drawn for a definite currency. In our opinion, a move may safely be made in this direction with the least possible delay so that the path may be cleared for the establishment of a bill market.

Creation of a Bill Market in India

The question of creating a bill market attracted the attention of the Reserve Bank of India on many occasions in the past. The issue was, however, brought to the forefront after the raising of the Bank Rate in India from 3 to $3\frac{1}{2}$ per cent in November 1951. It was in January 1952 that the Bill Market Scheme was evolved by the Reserve Bank of India in consultation with several of the representative bankers in Bombay and Calcutta. The scheme was introduced as an experimental measure in the first instance ; but, due to the popular response it received during the very first year, it has now been made a permanent feature of the Indian money market.

Previously, the scheduled banks had been generally raising funds for meeting their seasonal requirements either by sale of securities to the Reserve Bank or by borrowing from the Reserve Bank against Government securities under section 17 (4) (a) of the Reserve Bank of India Act, 1934. This system was not well suited for a qualitative control of seasonal credit expansion by the central banking authority and also did not make the Indian money market sufficiently flexible for the needs of trade and commerce. The Bill Market Scheme has been successful in overcoming these limitations.

The scheme is mainly based on the system under which the Imperial Bank of India (now State Bank of India), before the establishment of the Reserve Bank, could borrow funds during the busy season from the Currency Department against internal bills or hundis drawn for financing bona fide trade or by the conversion of advances granted for the same purpose.

The salient features of the Bill Market Scheme are as follows:—

Under section 17 (4) (c) of the Reserve Bank of India Act in terms of which the scheme will operate, all scheduled banks in possession of a licence granted under section 22 of the Banking

Companies Act, 1949 irrespective of the size of their deposits are eligible for advances against the security of usance promissory notes or bills of their constituents drawn on and payable in India and maturing within ninety days from the date of the advance. For this purpose, the scheduled banks are required to convert the demand promissory notes obtained by them from their constituents in respect of loans, overdrafts and cash credits granted to them into usance promissory notes maturing within ninety days. It should be specifically understood that the scheme provides for advances and not rediscounting facilities.

The scheme as originally formulated by the Reserve Bank was restricted during the first year to scheduled banks having deposits of Rs. 10 crores or more and the minimum limit of a loan and the minimum amount of each individual bill were fixed at Rs. 25 lakhs and Rs. 1 lakh respectively. The scheme was extended in June 1953 to scheduled banks having deposits (including deposits outside India) of Rs. 5 crores or more, provided they were in possession of a licence granted under section 22 of the Banking Companies Act, 1949. In July 1954 the Reserve Bank extended the scheme to all scheduled banks in possession of a licence granted under section 22 of the Banking Companies Act irrespective of the size of their deposits and also reduced the minimum limit of a loan to Rs. 10 lakhs and the minimum amount of each individual bill to Rs. 50,000.

Advances by way of demand loans against the security of bills eligible under section 17 (4) (c) are made after the Reserve Bank satisfies itself about the bona fide character of the bills as required by section 17 (4) (c) read with section 17 (2) (a) of the Reserve Bank of India Act. For this purpose, the Reserve Bank examines the proposals submitted by banks on the basis of the material supplied by them as well as by means of a scrutiny, where necessary, of the relevant accounts and records with them, together with outside inquiries.

Section 17 (4) (c) provides that each eligible bill should bear two or more good signatures one of which shall be that of the scheduled bank. The scheduled bank is, therefore, required to certify that its constituent who is a party of the bill is good for the amount.

As the scheme provides for the lodgement of bills as security

for loans from the Reserve Bank and not for their rediscount with it, it is open to the borrowing banks to withdraw any of the bills lodged as also to replace them by other eligible bills. Part repayments of the loans are permitted as usual.

In order to encourage the bill habit, the Reserve Bank decided to charge interest on advances under the scheme at ½ per cent below the Bank Rate *i.e.* at 3% per annum. The Reserve Bank also decided to bear half the cost of the stamp duty incurred in converting demand bills into usance bills, although with the reduction of the stamp duty on bills payable in less than one year to two annas for every thousand rupees or part thereof in January 1940, the incidence of the stamp duty was negligible. A further concession in this connection was made when in respect of usance bills drawn in part 'B' States the Bank agreed to refund with effect from October 1953 such portion of the stamp duty on these bills as was in excess of one anna for every thousand rupees or part thereof.

The above stipulations have been recently modified. Commencing from March 1, 1956, advances under the Bill Market Scheme are being made at 3¼ per cent, that is, a quarter per cent less than the bank rate instead of ½ per cent less. From the same date, the concession in respect of the stamp duty has also been withdrawn.

It should be noted here that the original intention of the Reserve Bank was to charge interest at a quarter per cent below the Bank Rate. As strong representations were received from the bankers who had been consulted, that a lower rate of interest would be fixed in the earlier years in order to popularise the scheme, the Reserve Bank decided to charge interest at half per cent below the Bank Rate, but made it clear that it might subsequently raise the rate at its discretion.

The withdrawal of the concession regarding stamp duty and the raising of the interest charges on advances by a quarter per cent were due to the following developments. The number of banks eligible to participate in the Bill Market Scheme has increased from 27 to 45 during the four years it has been in operation and advances availed of by banks have increased from Rs. 81 crores in 1952 to Rs. 225 crores in 1955. This would indicate that the scheme has been a striking success and that banks have been

making full use of the scheme to provide themselves with funds during the busy season. Apart from this, there has recently been a material change in the resources of the scheduled banks. The Bank rate or the lending rate against the security of bills remained at 3½% till May 15, 1957, when it was raised to 4%.

Under the conditions prevailing in India, the utmost which the Reserve Bank can do to relieve seasonal stringency in the Indian money market is to devise a scheme that will provide it with a mechanism for the extension of short-term credit for meeting the needs of trade and industry particularly during the busy season.

In the absence of a well-developed bill market like the London Discount Market and in the face of the preference on the part of the business community for bank advances, a suitable means of extending short-term credit with due regard to qualitative control has been found to be the conversion of short-term advances by banks to their constituents into a shiftable security viz., the usance bill. The Bill Market Scheme combines for the constituents of the banks the advantages of the cash credit system with those of the bill of exchange, permitting the borrower to make withdrawals and repayments into the account as often as before. As the scheme provides for advances and not rediscounting facilities, the banks are also able to minimise interest charges by borrowing according to their needs and by remitting spare funds to reduce their indebtedness. Further, although the bills thus created would by themselves be clean, they would, in most cases, be backed by some tangible security held by the banks in respect of the relative loan/overdraft/cash credit accounts. Consequently, the banks and in turn, their constituents would be in a position to raise much larger funds to meet adequately their busy season requirements.

The reasons why in India the bill market has not developed as fast as it should have done are as follows:

Firstly, the bulk of the financing of foreign trade is done by foreign banks commonly known as exchange banks. The majority of both the export and import bills are drawn in sterling and such bills are obviously not suitable for negotiation in a bill market in India. Further, in the absence of Acceptance Houses in India, export bills are invariably payable outside India and hence are not good for sale or eligible for rediscount with the Reserve Bank.

The import bills, on the other hand, are for small amounts and hence are not helpful in promoting a bill market. Secondly, in the case of movement of goods within the country, it is still customary for the seller to extend an open account credit rather than draw a bill. Even banks prefer giving cash credit or overdraft against the storage of goods pending movement rather than accept a bill, as they can, in the former case, recall the advance at a short notice in case the borrower's financial position is adversely affected. In the case of a bill, they would have to wait until its maturity.

The Bill Market Scheme has since been extended to export bills as well with a view to promoting exports. "The minimum amount of an individual usance promissory note to be lodged with the Reserve Bank as security for advances, which had been originally fixed at Rs. 20,000 and subsequently reduced to Rs. 10,000 in October 1959, was further reduced to Rs. 5,000 in January 1961. The stipulation requiring banks to ensure that the parties concerned either cover the exchange risk or maintain the specified margin in the relative loan accounts has been withdrawn and the matter has been left to the discretion of the banks concerned. The condition that export bills held by banks as security in the relevant loan accounts intended for conversion into time bills should have a usance of not more than 90 days has been waived, though the usance promissory notes lodged with the Reserve Bank must mature within 90 days. The scheme as applied to export bills, first introduced in October 1958, and continued up to the end of September 1960, now stands extended by another year up to the end of September 1961" (Report of the Reserve Bank's Central Board of Directors for the year ended June 30, 1961).

CHAPTER VII

INDIAN BANKING SYSTEM

Reserve Bank of India

The Reserve Bank of India was established in the year 1935, 1st of April, in accordance with the provisions of the Reserve Bank of India Act, 1934. The Royal Commission on Indian Currency and Finance recommended in 1925 that India should have a Central Bank of her own to control her currency and credit. Accordingly, a bill was introduced by Sir Basil Blackett, the then Finance Member of the Government of India, in the Legislative Assembly in the year 1927 (January 25). But unfortunately it had to be abandoned on constitutional grounds. The White Paper on Indian Constitutional Reforms took up the matter in 1933 and recommended the establishment of the Reserve Bank of India. According to that recommendation the Reserve Bank of India Act was passed in 1934.

Constitution.—Formerly, the Reserve Bank of India was a shareholders' bank having a share capital of Rs. 5 crores, divided into shares of one hundred rupees each fully paid-up. Out of these, shares worth Rs. 2 crores 20 lacs were allotted to the Central Government and the rest were distributed amongst private shareholders.

The affairs of the Bank were directed by the Central Board of Directors consisting of 16 members, namely, (*a*) a Governor and two Deputy Governors appointed by the Central Government on the recommendations of the Central Board, (*b*) four Directors nominated by the Central Government, (*c*) eight Directors elected on behalf of the shareholders, (*d*) and one Government Official nominated by the Central Government. As it was not possible for the Central Board to look after the details of the affairs of the Bank in its various centres, it was thought expedient to delegate some of its functions to four Local Boards. Each Local Board was composed of (*a*) five members elected by the shareholders and

(*b*) not more than three members nominated by the Central Board from amongst the shareholders.

After the Bank had been nationalised on the 1st January, 1949 under the Reserve Bank (Transfer to Public Ownership) Act, 1948, the Central Board shall consist of (*a*) a Governor and three Deputy Governors to be appointed by the Central Government, (*b*) four Directors to be nominated by the Central Government, one from each of the four Local Boards, (*c*) six Directors to be nominated by the Central Government, and (*d*) one Government official to be nominated by the Central Government. A Local Board shall be constituted for each of the four areas and shall consist of three members to be appointed by the Central Government to represent as far as possible territorial and economic interests and the interests of co-operative and indigenous banks. A director nominated by the Central Government is to hold office for a period of four years—so also a member of the Local Board.

Functions of the Bank.—It was clearly stated in the preamble to the Act that the Bank was constituted to regulate the issue of notes and the keeping of reserves with a view to securing monetary stability and to operating the currency and the credit of the country to its advantage. Under Section 22 of the Act, the Bank has the sole right to issue notes. For the issue of notes the Bank runs a separate department called the Issue Department whose assets are kept distinct from those of its Banking Department. The assets of the Issue Department are to consist of gold coins, gold bullion, sterling securities, rupee coin and rupee securities. Of the total assets, not less than 40% was to consist of gold coin, gold bullion, or sterling securities provided that the amount of gold coin and gold bullion shall not at any time be less than Rs. 40 crores in value. This currency reserve provision has been amended by the Reserve Bank of India (Amendment) Act, 1956, which now provides for a minimum holding of Rs. 400 crores in foreign securities and of Rs. 115 crores in gold in the Issue Department of the Bank and also for revaluing the gold holdings at the rate agreed by the International Monetary Fund, namely, Rs. 62-8-0 per tola. It is, however, permissible to hold less than 40% for a temporary period on payment of a specified tax on the deficiency. Provision has, however, been made to suspend temporarily the assets requirements in respect of foreign securities provided that the amount of foreign

securities, held in the Issue Department, shall not at any time be less than Rs. 300 crores in value. Sterling assets which can be held in the Issue Department are limited to (*a*) balances with the Bank of England, (*b*) bills of exchange bearing two or more good signatures and drawn and payable in any place in the U.K. and having a maturity not exceeding 90 days and (*c*) Government securities of the U.K. maturing within five years. Section 28A of the Reserve Bank of India Act empowers the Reserve Bank and the Central Government to issue special bank notes and special one-rupee notes for the purpose of controlling the circulation of bank notes outside India. The main object of this section is to check the drain on India's foreign exchange reserves arising from conversion into sterling of large amounts of Indian notes smuggled out for financing the smuggling of gold and other commodities into India.

The Bank is further authorised to keep the balance of commercial banks, notably the scheduled banks, which, under Section 42 of the Act, are to maintain 2% of the time liabilities and 5% of demand liabilities as statutory deposits. This provision has been amended in 1956. Non-scheduled banks are also permitted to keep balances with the Bank. These statutory deposits enable the Bank to influence, to a large extent, the credit policy of the member banks. However, these statutory deposits place at the disposal of the bank sufficient resources whereby the bank can help the scheduled banks in times of emergency. But it should be noted in this connection *that the Reserve Bank of India is authorised by the Act to grant* only temporary accommodation and not any long-term credit for speculation or overtrading.

As regards extension of agricultural credit, the Bank is playing a useful role. The Bank, as a matter of principle, cannot extend credit for meeting the long-term needs of agriculture. It can, at the most, purchase or rediscount agricultural bills drawn for seasonal agricultural operations or the marketing of crops and maturing within fifteen months from the date of such purchase or rediscount.

As a Central Bank of the country the Reserve Bank is to maintain the external value of the rupee and is required for this purpose to sell and buy sterling within certain rates fixed by the Act.

As a banker to Government, the Reserve Bank of India is to accept and dispose, under Section 20 of the Act, moneys for account of the Central Government, and the State Governments, and to carry out their exchange, remittance and other banking operations, including the management of the public debt. In times of necessity the Bank is to grant ways and means advances to the Governments.

Apart from the above functions, the Bank performs a number of subsidiary functions like the supplying of different forms of currency, the extension of remittance facilities, the management of clearing houses, the tendering of advice on financial matters, collection and dissemination of banking statistics etc.

Hereafter we shall be discussing some of the functions in fuller details.

Banker to Government and Other Banks

The Reserve Bank is entrusted with the banking business of the Central Government free of charge. Further it is to look after the management of the public debt and the issue of the new loans. For the management of the public debt the Bank is entitled to some remuneration at an agreed rate from the Central Government. The Bank is required to maintain currency chests of its Issue Department at places prescribed by the Government, and to extend reasonable remittance facilities to the public at those places. The Bank is further required under agreement to remit on account of Government between India and London funds by telegraphic transfers or otherwise.

Besides this, the rupee-loans of the Central Government are floated through the Public Debt Office of the Bank. Treasury bills, which constitute a form of short-term borrowing by the Government, are sold through the Reserve Bank of India. When Treasury bills are not found suitable for raising funds for a short period the Bank grants ways and means advances to the Government for a temporary period.

The Reserve Bank undertakes to supply the sterling requirements of Government, for which it purchases sterling from the scheduled banks from time to time for an amount not less than the equivalent of one lac of rupees.

In the above manner the Bank also maintains the accounts of the State Governments, meets their ways and means advance requirements, helps them in the floatation of Treasury bills and other loans.

By virtue of its closer association with the money market and its intimate knowledge of the monetary conditions the Reserve Bank of India is often required to advise the Government on financial and banking matters. Its advice is often sought by the Government in respect of issue of new loans, conversions, investment of funds, agricultural credit, co-operation, legislation affecting banking and credit.

Scheduled and Non-Scheduled Banks.—Conditions which are to be fulfilled by a scheduled bank are laid down in Section 42(6) of the Reserve Bank of India Act. A bank must have a paid-up capital and reserves of an aggregate exchangeable value of not less than five lacs of rupees if it is to be eligible for inclusion in the Second Schedule to the Act.

The scheduled banks form a heterogeneous group. The State Bank of India, which is also the agent of the Reserve Bank of India, is a class by itself. Next to it come the exchange banks incorporated outside India. Then come the Indian scheduled banks including the Big Five of India.

Before permitting inclusion in the Second Schedule to the Act, the Reserve Bank of India causes an inspection to be made of the affairs of the applicant bank. The inclusion of a bank in the Second Schedule is no continuing guarantee of its soundness or stability, but the inclusion may be cancelled if the Reserve Bank of India is subsequently satisfied that the affairs of any such bank are not being conducted satisfactorily.

A scheduled bank is compulsorily to maintain under Section 42(1) of the Act a statutory balance of not less than 5% of its demand and 2% of its time liabilities. This provision has been amended by the Reserve Bank of India (Amendment) Act, 1956. In terms of the amended provision every scheduled bank will be required to maintain with the Reserve Bank an average daily balance the amount of which shall not be less than 5 per cent of the demand liabilities and 2 per cent of the time liabilities in India of such banks provided that the Reserve Bank may, by a notification in the Gazette of India, increase the said rates to such higher

in unsecured business to an excessive extent. It is to be noted in this connection that the Reserve Bank is empowered by the Act to grant only temporary accommodation. With a view to ensuring that its credit facilities are not abused in any way the Reserve Bank may call for such information or impose such conditions as it may consider necessary, and a scheduled bank requiring assistance from the Reserve Bank is expected to supply such information as may be called for."

Discounts.—Section 17(2) (*a*) authorises the Reserve Bank of India "to purchase, sell or rediscount bills of exchange, promissory notes, drawn on India and payable in India and arising out of *bona fide* commercial or trade transactions bearing two or more good signatures, one of which shall be that of a scheduled bank or a State Co-operative Bank, and maturing within *ninety days* from the date of such purchase or rediscount, exclusive of days of grace." The promissory notes or bills of exchange acceptable for rediscount should satisfy the following conditions:

I. It should be a bill of exchange or promissory note as defined in the Indian Negotiable Instruments Act.

II. It must arise out of *bona fide* trade or commercial transactions. Before accepting a bill, the Reserve Bank will require a scheduled bank to keep the Reserve Bank informed of the credit, means and integrity of the drawers and drawees of the bill and accordingly a prescribed form was distributed amongst scheduled banks for submission of such information.

III. It must bear two or more good signatures, one of which is that of a scheduled bank.

IV. It must have a fixed maturity, not exceeding 90 days, excluding days of grace, from the date of purchase or rediscount by the Reserve Bank. If any bill or promissory note is payable on demand, it will not be acceptable to the Reserve Bank as these instruments have no fixed maturity. A promissory note to be acceptable for rediscount should be drawn to finance a definite business transaction, which should be liquidated within a specified period as indicated on the bill. As demand promissory notes have no fixed maturity they are not eligible under this Section. This difficulty has been overcome by instruc-

tions being given to scheduled banks to convert their bills of exchange or promissory notes into usance bills or usance promissory notes.

Section 17(2) (*b*) authorises the Reserve Bank to purchase, sell, or rediscount agricultural bills which satisfy the following conditions:

I. That they are drawn and payable in India,

II. that they bear two or more signatures one of which is that of a scheduled bank or a State co-operative bank,

III. that they are drawn or issued for the purpose of financing seasonal agricultural operations or the marketing of crops, and

IV. that they mature within 15 months from the date of purchase or rediscount by the Reserve Bank exclusive of days of grace.

Section 17(2) (*c*) authorises the Reserve Bank to "purchase, sell, and rediscount bills of exchange and promissory notes drawn either in India bearing the signature of a scheduled bank and issued or drawn for the purpose of holding or trading in securities of the Central Government, a State Government and maturing within 90 days from the date of such purchase or rediscount exclusive of days of grace." Advances against Government or other gilt-edged securities are made not under this section but under section 17(4)(*a*). This sub-section was intended "for the contingency of the development of a bill-market which would finance dealings in Government securities and therefore inapplicable in the absence of such a market".

Section 17(3) (*b*) authorises the Reserve Bank to "purchase or sell or rediscount bills of exchange (including Treasury bills) drawn in any country outside India which is a member of the International Monetary Fund and maturing within 90 days from the date of purchase, provided that no such purchase, sale or rediscount shall be made in India except with a scheduled bank."

Effective use of Section 17(2) seems to be dependent upon the availability of a large amount of time bills and time promissory notes. In spite of the reduction of the stamp duty on usance bills effected by Government in 1940, growth in the bill habit has not been significant. A major portion of the advances of banks, secured and unsecured, still consists of cash credits, loans or over-

drafts against demand promissory notes drawn by their constituents. The lack of popularity of bills in India seems due to the less expensive character and more convenient form of borrowing by overdrafts or cash credits.

Advances.—(*a*) Section 17 (4) (*a*) authorises the Reserve Bank to make to scheduled banks, the State co-operative banks, etc. loans and advances repayable on demand or on the expiry of fixed periods not exceeding 90 days against the security of stocks, funds, and securities (other than immovable property) in which a trustee is authorised to invest trust money by any Act of Parliament of the United Kingdom or by any law for the time being in force in India. The securities must be readily marketable and selected for advances by the Reserve Bank on the merits of each such security.

(*b*) Section 17(4) (*c*) & (*d*) authorises the Reserve Bank to make to scheduled banks, State co-operative banks, etc., loans and advances, repayable on demand or on the expiry of fixed periods not exceeding 90 days, against bills of exchange and the security of promissory notes of any scheduled bank or State co-operative bank supported by documents of title to goods which have been transferred, assigned or pledged to any such bank as security for a loan or advance made for *bona fide* commercial or trade transactions, or for the purpose of financing seasonal agricultural operations or the marketing of crops. This sub-section restricts the facility to "documents of title to goods" and not to "goods". Scheduled banks may obtain rediscounting facilities from the Reserve Bank against endorsement of documents of title to goods. Documents of title to goods as defined in Section 2 of the Indian Sale of Goods Act include "a bill of lading, dock warrant, warehouse-keepers' certificates, wharfinger's certificates, railway receipts, warrant or order for the delivery of goods and other documents used in the ordinary course of business as proof of the possession of or control of goods or authorising or purporting to authorise either by endorsement or by delivery the possessor of the document to transfer or receive goods thereby represented". Of these only the negotiable instruments are acceptable. In order to give effect to this section the establishment of the licensed warehouses is an indispensable necessity. In this connection it may be mentioned that several States have already enacted warehousing

legislations and a number of licensed warehouses have since but set up in different parts of the country.

THE RESERVE BANK OF INDIA ACT

Important Amendments in 1957

Under Section 17(4A) the Reserve Bank is authorised to make loans and advances to any State Financial Corporation established under the State Financial Corporations Act, 1951, repayable on the expiry of fixed periods not exceeding eighteen months against government (Central and State) securities and bonds and debentures of such corporations and guaranteed by the State Government concerned and maturing within eighteen months, provided that the amounts of such loans and advances do not exceed, at any time, in the aggregate sixty per cent of each................paid up share capital.

Under section 17(4AA) of the Act, the Reserve Bank is further authorised to make loans and advances out of the National Agricultural Credit (Long-term Operations) Fund and the National Agricultural Credit (Stabilisations) Fund to a State co-operative bank up to an amount not exceeding the latter's owned funds provided the amount of such loans does not also exceed Rs. 5 crores in the aggregate at any time.

Under section 17(4B) it can also make advances to the Industrial Finance Corporation of India against Government securities, debentures issued by the latter and guaranteed by the Central Government and maturing within eighteen months from the date of such advance provided the aggregate amount of such loans does not exceed Rs. 3 crores.

Section 17(4BB) also authorises the Reserve Bank to grant loans and advances to any financial institution against Government securities for periods varying between ninety days and eighteen months.

Provision has also been made in section 17 (4C) for the grant of loans and advances by the Reserve Bank to the Warehousing Corporations established under the Agricultural Produce (Development and Warehousing) Corporations Act, 1956. Such ad-

vances may be made against Government securities either repayable on demand or on the expiry of fixed periods not exceeding 90 days or against bonds and debentures issued by the Corporation to which the loan is made and guaranteed by the Central or State Government and maturing within a period not exceeding eighteen months from the date of such loan or advance provided the amount of such loans shall not exceed at any time in aggregate sum of Rs. 3 crores in case of the Central Warehousing Corporation and Rs. 55 lakhs in the case of a State Warehousing Corporation.

It has been pointed out by the Reserve Bank in one of its reports that the experience of the working of section 17 has been that although the provisions thereof are sufficient to meet the normal requirements of scheduled and state co-operative banks, they do not provide for an emergency to enable banks not in possession of requisite securities to borrow from the Reserve Bank. Accordingly Section 18 was amended authorising the Reserve Bank to grant advances to banks against such security as it may consider sufficient in an emergency. In the event of the liquidation of the borrowing bank, the Reserve Bank will have, in terms of section 18(2) of the Reserve Bank of India Act, the first charge upon its assets subject to the claims, if any, of any other banking company in respect of any prior loans made against any security.

Remittance Facilities.—The scheduled banks enjoy certain remittance facilities from the Reserve Bank at concession rates.

Non-Scheduled Banks.—The Reserve Bank now permits opening of accounts by non-scheduled banks on certain conditions. The Bank is required to tender advice to non-scheduled banks when asked for. In two Circular Letters issued by the Reserve Bank to non-scheduled banks in 1938 and 1939, it indicated the manner in which it is prepared to help the non-scheduled banks.

Agricultural Credit Department of the Bank.—The Reserve Bank maintains an Agricultural Credit Department of its own since April, 1935 in accordance with the provisions of Section 54 of the Act. Its statutory functions are (*i*) to maintain an expert staff to study all questions of agricultural credit and be available for consultation by the Government, State Government, the provincial co-operative banks and other banking organisations, (*ii*) to co-ordinate the operations of the Bank in connection with agricul-

tural credit and its relations with provincial co-operative banks and any other banks or organisations engaged in the business of agricultural credit. The Department makes a special study of rural finance, co-operation, legislation for the relief of rural indebtedness and records its observations in the form of bulletins issued by the Department from time to time.

The Reserve Bank has the duty of supplying finance to co-operative institutions with a view that the said finance ultimately percolates to the agriculturists. Under the statute it is not permitted to make direct advances to the agriculturists but can do so only through the provincial co-operative banks. As a central banking institution it is not to supply normal finance to the state co-operative banks, which are to raise their own resources. Moreover, the financial assistance can be rendered by the Reserve Bank only in times of emergency to overcome temporary financial stringency.. In a Circular Letter No. ACD 590/70-38 of the 14th May, 1938, to provincial co-operative banks, the Reserve Bank laid down in details the procedure for financial assistance. One of those conditions is that a provincial co-operative bank should have to maintain with the Reserve Bank 2½% of the demand liabilities and 1% of the time liabilities on the close of business every day.

The Reserve Bank is authorised to extend financial assistance to the co-operative movement under the following heads:

(*a*) Loans and advances against Government securities to state co-operative banks and through them to central co-operative banks for a period of 90 days.

(*b*) Similar loans and advances to state co-operative banks against approved debentures of recognised land-mortgage banks which are declared as trustee securities and which the Reserve Bank considers to be readily marketable.

(*c*) Discount of Treasury bills.

(*d*) Loans and advances for periods not exceeding 90 days to state co-operative banks against promissory notes of approved co-operative marketing or warehouse societies endorsed by state co-operative banks and drawn for the marketing of crops; or rediscount of such promissory notes maturing within nine months; or loans and advances for periods not exceeding 90 days on the promissory notes of state co-operative banks secured by ware-

house warrants issued by corporations independent of the borrower or on the security of promissory notes supported by documents of title to goods which have been assigned or pledged as security for a loan or advance made by the state co-operative banks to approved marketing or warehouse societies.

(e) The maximum period of advance is 15 months intended primarily for financing seasonal agricultural operations or marketing of crops.

Bills or promissory notes offered for purchase or rediscount must bear two good signatures, one of which should be that of a state co-operative bank. The second signature appearing on the bill must necessarily be of a central bank, whose soundness must be unimpeachable in the opinion of the Reserve Bank. Such bills *must mature within fifteen months from the date of purchase or* rediscount by the bank. The bills or promissory notes must be drawn in proper legal form so that they may be treated as negotiable instruments. It is said that the promissory notes of the co-operative societies are governed by certain restrictions which militate against the free negotiability of such instruments. For the purpose of rediscounting with the Reserve Bank the agricultural paper must take the form of a usance bill or a usance promissory note drawn by the co-operative central bank and endorsed by the State co-operative bank.

The Reserve Bank is further authorised to help the land-mortgage banks by purchasing their debentures or granting advances against those debentures, provided they are fully guaranteed as to the repayment of the principal and payment of interest by the State Government.

The Reserve Bank issued a separate bulletin wherein certain definite suggestions have been made to improve the affairs of co-operative credit societies, village banks, central banks and of land-mortgage banks. Its recommendations for the rehabilitation of the co-operative movement deserve immediate execution. The bank entered into negotiation with indigenous bankers for bringing them under its sphere of influence and prepared a blue print for their acceptance. But unfortunately, that scheme has not been found acceptable to the indigenous bankers who consider it too revolutionary

DEPARTMENT OF BANKING OPERATIONS

It has been pointed out by the Bank in its report for the year 1949 that the Department of Banking Operations, which is entrusted with the administration of the Banking Companies Act, 1949, was originally organised in August 1945 to provide the requisite administrative machinery to discharge the several duties and responsibilities which were expected to devolve upon the Reserve Bank after the passing of the Banking Companies Bill, which was under the consideration of the Legislature at the time. Prior to the passing of the Act, the Department, apart from its duties in relation to scheduled banks under the Reserve Bank of India Act, 1934, was engaged mainly in the administration of the Banking Companies (Inspection) Ordinance 1946, the Banking Companies (Restriction of Branches) Act 1946 and the Banking Companies (Control) Ordinance 1948, all of which have been repealed by the Banking Companies Act 1949. The Central Office of the Department is located in Bombay. For administrative purposes, the Department is divided into three Divisions, namely, the Operations Division, the Inspections Division and the Liquidations Division, dealing respectively with the scrutiny of returns received from banking companies and general administrative matters, the inspections and liquidations of banking companies. The Department has established a branch each at Calcutta, Madras, Delhi, Kanpur, Trivandrum, Nagpur and Bangalore. The Central Office at Bombay generally deals with matters of policy relating to the Banking Companies Act, while the branch offices look after the actual administration of the Act with regard to the banking companies within their respective areas.

DEPARTMENT OF BANKING DEVELOPMENT, ECONOMIC DEPARTMENT, STATISTICS DEPARTMENT AND INDUSTRIAL FINANCE DEPARTMENT

The Department of Banking Development was created in October 1950, mainly with the object of giving concentrated attention to the extension of banking facilities to semi-urban areas and to the problems of rural finance. One of the principal duties of the new Department has been to implement the recommendations of the Rural Banking Enquiry Committee. Other activities of the

Department include an examination of the effects of the Bank Award on the financial position of banks and on banking facilities and a scrutiny of the State Financial Corporations Bills. It also deals with matters connected with the State Bank of India and its subsidiaries and gives attention to questions, such as extension of cheap remittance facilities, reform of treasuries, etc. It provides a liaison between the Reserve Bank and the small savings movement.

Besides the above the Bank also maintains the Economic Department and Statistics Department for conducting research work in economic matters and related topics. These Departments keep in close touch with the current economic and financial developments, both in India and abroad.

The Industrial Finance Department was created in September 1957. It deals with all matters relating to industrial finance, including the activities of the State Financial Corporations and looks after the affairs of the Refinance Corporation for Industry etc.

Exchange Control.—Part XIV of the Defence of India Rules issued under the Defence of India Act, 1939, provides for the control of all dealings in foreign exchange. Now the exchange control has become a semi-permanent feature of the Reserve Bank's working in view of the present exchange position. According to Rule 94 of Part XIV of the Defence of India Rules, the following restrictions were imposed:

I. Acquisition of any foreign exchange by residents in India was prohibited.
II. Only authorised dealers had the authority to deal in such foreign exchange.
III. Foreign exchange could be acquired for certain purposes, for reasonable travelling or personal expenses subject to the approval of the Reserve Bank of India.

Remittances were divided into five categories:

(*a*) Payment of imports,
(*b*) Petty private remittances,
(*c*) Travelling expenses,
(*d*) Other trade purposes (*i.e.*, freight, profits and royalties etc.),
(*e*) Capital remittances.

Each authorised bank is to submit to the Reserve Bank of India every day a statement of its actual sales of foreign exchange

supported by application forms. The Exchange Control Department is to scrutinise these applications and is to satisfy itself about the observance of the exchange regulations.

To intensify control over exchange, an export control scheme was also instituted. The object is to see that the foreign exchange proceeds of exports are returned to India and not retained abroad, that exports are financed in certain specified ways, so that the maximum exchange value is obtained. The Exchange Control Department assists authorised dealers in foreign exchange operations. Authorised dealers are to submit every week a statement to the Reserve Bank showing their exchange position and if they are found to be heavily overbought they are required to sell their surplus foreign exchange holdings to the Bank of England unless they can satisfy the Reserve Bank that they are required for local sales.

The financial provisions of the Defence of India Rules, which were extended by the Emergency Provisions (Continuance) Ordinance (1946), were given statutory recognition with certain modifications by the passing of the Foreign Exchange Regulation Act, 1947, which came into force on the 25th March, 1947. The Act gives a new lease of life to the existing system of Exchange Control for a period of another five years with power to continue it for a further period of three years. The Act *inter alia* provides for the following:

I. Restrictions on dealing in Foreign Exchange
II. Restrictions on import and export of certain currency and bullion
III. Acquisition by the Central Government of Foreign Exchange
IV. Regulation of export and transfer of securities
V. Acquisition by the Central Government of foreign securities.

The Central Government have (*i*) authorised the Reserve Bank of India to deal in foreign exchange and (*ii*) empowered the Reserve Bank of India to authorise on its behalf other persons to deal in foreign exchange, gold coin and bullion. An authorisation (*i*) may authorise dealings in all foreign currencies or may be restricted to authorised dealings in specified foreign currencies only, (*ii*) may authorise transactions of all descriptions in foreign

currencies or may be restricted to authorised specified transactions, only, or (*iii*) may be granted to be effective for a specified period or within specified amounts. Authorisations are ordinarily granted only to those banks which have offices in India, are included in the second schedule to the Reserve Bank of India, and have had exchange dealings with the Reserve Bank of India in the past. The Reserve Bank of India, may, without assigning any reason, refuse to grant or withdraw, if already granted, the authorisation of any bank to deal in foreign exchange, if in its opinion such a bank has acted contrary to any of the provisions of the Foreign Exchange Regulation Act or any instructions issued by the Reserve Bank of India from time to time.

The statutory functions delegated by the Central Government are administered by a separate department of the Reserve Bank of India called the Exchange Control Department. The Governor of the Reserve Bank of India, in his capacity of the Chief Executive of the Bank, is the Controller. The Central Office of the Department is situated in Bombay under the immediate charge of the Deputy Controller who is also in charge of the local office of the Department at Bombay. The Department has also offices at Calcutta, Madras, Delhi and Kanpur, each of which is in charge of an Assistant Controller. Forms, Returns etc. are required to be sent to that office of the Reserve Bank of India which is nearest to the place of business of the authorised dealers.

Interpretation.—In terms of the Foreign Exchange Regulations Act (F. E. R. A.)—

(*a*) 'Currency' includes all coins, Currency Notes, Bank Notes, Postal Notes, Money Orders, Cheques, Drafts, Traveller's Cheques, Letters of Credit, Bills of Exchange and Promissory Notes ;

(*b*) 'Foreign Currency' means any currency other than Indian currency ;

(*c*) 'Foreign Exchange' means foreign currency and includes all deposits, credits and balances payable in any foreign currency and any drafts, traveller's cheques, letters of credit and bills of exchange, expressed or drawn in Indian currency but payable in any foreign currency ;

(*d*) 'Foreign Security' means any secuirty issued elsewhere than in India and any security, the principal or the

interest of which is payable in any foreign currency or elsewhere than in India ;

(e) 'Gold' includes gold in the form of coin, whether legal tender or not or in the form of bullion or ingot, whether refined or not ;

(f) 'Indian Currency' means currency which is expressed or drawn in Indian rupees.

It follows, therefore, that all currencies other than Indian currency must be regarded as foreign currency. Sterling and the currencies of other countries within the 'Sterling Area' also constitute foreign exchange. When the Foreign Exchange Regulation Act was passed exemption from control was given to currencies of 'Sterling Area' territories, but since the implementation of the Financial Agreement between India and the U.K. in August, 1947, a comprehensive system governing transactions in sterling area also was introduced from 1st September, 1947. Currencies of all countries are now subject to exchange control regulations under the Foreign Exchange Regulation Act.

Sterling Area.—'Sterling Area' which is also defined as 'Scheduled Territory' under the British Exchange Control Act, 1947, includes the following territories:

(1) The United Kingdom.
(2) Any Dominion within the meaning of the Statute of Westminster, 1931 except Canada and New Foundland
(3) Any part of His Majesty's Dominions, not being a Dominion within the meaning of the Statute of Westminster, 1931 or a part of such Dominion.
(4) Any British Protectorate or British Protected State.
(5) Any territory held by His Majesty's Government in the United Kingdom or in any Dominion in respect of which a mandate on behalf of the League of Nations was accepted by His Majesty or which is held in trust on behalf of the United Nations by the Government excluding Palestine.
(6) Iraq.
(7) Iceland.
(8) Faroe Island.

Payments for imports, private purposes, maintenance etc. to countries within the sterling area may be made in sterling, in

the currency of the country in which remittance is desired or in rupees.

Payments in other countries have been classified as follows:—

DESCRIPTION OF TERRITORIES	PRESCRIBED METHODS OF PAYMENT
A. The Argentine republic, Bolivia, Brazil, Chile, Paraguay, Peru, Spain and Spanish Territories, Overseas and Uruguay (Special account countries).	1. Payment in sterling or rupees to a special account of a resident in the country concerned
B. The United States of America, any territory under the sovereignty of the U.S.A., Philippine Islands, Equador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Salvador and Venezuela (American account countries).	1. Payment in sterling or rupees to the account of a resident in any of the countries listed. (American account) 2. Payment in U.S. dollars
C. 1. Belgium Monetary Area (Belgium, Belgian Congo Ruanda-Urundi & Luxemburg)	1. Payment in sterling or rupees to the account of a resident in any country in the area (Belgian Account) 2. Payment in Belgium Luxemburg, or Congolese francs.
2. Canada & Newfoundland	1. Payment in sterling or rupees to the account of a resident in Canada or Newfoundland. 2. Payment in Canadian or Newfoundland dollars.
3. China & Manchuria	Payment in sterling or rupees to the account of a resident in China or Manchuria (China account)

DESCRIPTION OF TERRITORIES	PRESCRIBED METHODS OF PAYMENT
4. Czechoslovakia	Payment in sterling or rupees to the account of a person resident in Czechoslovakia (Czech account)
5. Denmark (excluding the Faroe Islands) and Greenland	1. Payment in sterling or rupees to the account of a person resident in Denmark (Danish accounts) 2. Payment in Danish kroner
6. Dutch Monetary Area (The Netherlands and Netherland East and West Indies)	1. Payment in sterling or rupees to the account of a person resident in any of the territories in the area (Dutch account) 2. Payment in the currency of any territory in the area.
7. Finland	1. Payment in sterling or rupees to the account of a person resident in Finland (Greek account)
8. French Franc Area (French and French Overseas Empire, Syria and Lebanon)	1. Payment in sterling or rupees to the account of a person resident in any of the territories in the area (French account) 2. Payment in the currency of any territory in the area
9. Greece	Payment in sterling or rupees to the account of a person resident in Greece (Greek account)
10. Italy	Payment in sterling or rupees to the account of a person resident in Italy (Italian account)

DESCRIPTION OF TERRITORIES	PRESCRIBED METHODS OF PAYMENT
11. Norway	1. Payment in sterling or rupees to the account of a person resident in Norway (Norwegian account) 2. Payment in Norwegian kroner
12. Poland	1. Payment in sterling or rupees to the account of a person resident in Poland (Polish account)
13. Portuguese Monetary Area (Portugal and Portuguese Empire)	1. Payment in sterling or rupees to the account of a person resident in any of the territories in the area (Portuguese account) 2. Payment in Portuguese escudos
14. Sweden	1. Payment in sterling or rupees to the account of a person resident in Sweden. 2. Payment in Swedish kroner
15. Switzerland and Liechtenstein	1. Payment in sterling or rupees to the account of a person resident in Switzerland or Liechtenstein (Swiss account) 2. Payment in Swiss francs
16. Turkey	1. Payment in sterling or rupees to the account of a person resident in Turkey (Turkish account)
17. Yugoslavia	1. Payment in sterling or rupees to the account of a person resident in Yugoslavia (Yugoslav account)

DESCRIPTION OF TERRITORIES	PRESCRIBED METHODS OF PAYMENT
18. Austria	1. Payment in sterling or rupees to the account of a person resident in Austria (Austrian account)
19. Hungary	1. Payment in sterling or rupees to the account of a person resident in Hungary (Hungarian account)
20. Egypt	1. Payment in sterling or rupees to the account of a person resident in Egypt (Egyptian account)
21. Anglo-Egyptian Sudan	1. Payment in Egyptian Pound. Payment in sterling or rupees to the account of a person resident in Sudan (Sudanese account)
22. Bulgaria	1. Payment in sterling or rupees to the account of a person resident in Bulgaria (Bulgarian account)
23. U.S.S.R.	1. Payment in sterling or rupees to the account of a person resident in U.S S.R.

N.B. Payments in sterling or rupees mentioned above are effected through the accounts of banks maintained in the U.K. or in India respectively. Payments in the currencies of the countries mentioned are chiefly effected through the accounts maintained by authorised dealers in India with their correspondents in those countries.

1.—Payments Against Imports

Imports of all goods into India are now subject to licences. Import licences are issued in duplicate by Import Trade Controllers, the Chief Controller of Imports, the Steel Controller and Machine Tool Controller, the first copy being marked 'for customs

purposes' and the second 'for exchange control purposes'. No letter of credit may be opened or remittance of foreign exchange made by an authorised dealer covering an import of goods into India unless the importer is in possession of an import licence marked 'for exchange control purposes'. Import licences not so marked are not sufficient authority for the remittance of foreign exchange or the opening of a letter of credit. When letters of credit are opened for financing imports, the licence for 'exchange control purposes' is required to be submitted to the authorised dealer who will endorse on the reverse the date on which the amount of the letter of credit was opened. If the limiting factor of the licence is value, the amount of the letter of credit opened should not exceed the value of the licence. The licence for 'exchange control purposes' is endorsed by the authorised dealer when remittance is actually effected by retirement of the bill drawn under a letter of credit or otherwise. The licence for 'customs purposes' is required to be submitted to the customs when goods are cleared. Although remittances for imports are effected against shipping documents, it is the duty of an authorised dealer to see that the exchange control copy of the relative customs entry form is submitted to the Reserve Bank within three months thus showing that the goods, for which remittances are made, have actually entered into India. When goods are imported without any valid licence, permission to clear them is sometimes given by the Import Trade Controller on payment of penalty. In such cases remittances cannot be effected without the prior approval of the Reserve Bank of India. Applications for such remittances should be accompanied by the exchange control copy of the relative Bill of Entry and be forwarded to the Reserve Bank of India for their approval through the authorised dealer through whom remittance is desired. Remittance of foreign exchange for imports may be made by authorised dealers without prior reference to the Reserve Bank provided the following conditions are fulfilled:

(*a*) remittance is made to the country of origin of the goods ;

(*b*) the exchange control copy of the import licence is produced ;

(*c*) remittance is made:—

(1) in retirement of bills,

(2) against delivery of shipping documents.

Remittances representing proceeds of consignment goods should be referred to the Reserve Bank unless special arrangements have been made.

2.—Personal and Private Remittances

These may be divided into three categories and different treatment will be accorded to each category. These are as follows:

(1) Remittances by Nationals of the Sterling Area.

(2) Remittances by Foreign Nationals resident in India.

(3) Remittances by Indian Nationals and persons domiciled in India.

(1) *Remittances by Nationals of the Sterling Area.*—Authorised dealers are permitted to allow private remittances by nationals of the sterling area temporarily resident in India but not domiciled in India in any currency of the sterling area up to a maximum of £150 per month by each individual. Remittances may be allowed for purposes, such as the support of families, payment of insurance premiums, legal charges etc., without the prior approval of the Reserve Bank provided that the aggregate remitted under all heads does not exceed £150 per month per person. Remittances of capital assets which may be taken to include the sale proceeds of shares, securities, estates, and properties, business partnerships, and provident funds and gratuity by non-Indians of the U.K. or sterling area origin at the time of retirement to the sterling area may be approved provided the amount remitted including bank balances does not exceed £1000 in any one case. Applications in excess of the above amounts should be referred to the Reserve Bank for their approval. Remittances by nationals of the sterling area for maintenance of their families temporarily resident outside the sterling area may be made only with the prior approval of the Reserve Bank of India.

(2) *Remittances by Foreign Nationals Resident in India.*—Foreign nationals who were resident in India prior to the 14th January, 1942, are permitted to make reasonable remittances to their own countries for support of families, payment of insurance premiums etc. Original applications should be forwarded to the Reserve Bank of India for approval when monthly limits for future

remittances will be fixed. Original applications should be accompanied by a statement in the appropriate form giving full particulars regarding the applicant with a declaration to the effect that the remittance of the sum applied for does not involve any payment to a person outside the sterling area either directly or indirectly on behalf of any person residing in the sterling area other than the remitter.

(3) *Remittances by Indian Nationals.*—Remittances by Indian nationals to relatives and dependants temporarily resident either in the sterling area or outside it may only be made with the prior approval of the Reserve Bank. Applications for such remittances should be accompanied by a declaration giving full particulars regarding the beneficiary and the sources of funds to be remitted. The Reserve Bank of India will issue permit and recurring remittances may only be made by authorised dealers on the strength of such permits without further reference to the Reserve Bank.

Indian Students.—Applications from Indian students to take University courses either in the sterling area or outside it should be referred to the Reserve Bank of India. The application forms which are supplied by the Reserve Bank are usually to be accompanied by a certificate from the University to the effect that the student has been admitted into the University. The Reserve Bank while approving the application will fix a monthly limit and also specify the period for which remittances can be effected.

3.—Travel Purposes

The following scales of allowances have been fixed by the Reserve Bank of India and remittances in these scales may be made by authorised dealers without any further reference to them:

I. Personal Convenience—

TYPE OF TRAVELLER	COUNTRY TO WHICH TRAVELLING	PERMISSIBLE EXCHANGE
A. INDIAN NATIONALS	1. All countries except those stated in 2, 3 & 4 below.	£150 per month per adult and £75 per month per child

TYPE OF TRAVELLER	COUNTRY TO WHICH TRAVELLING	PERMISSIBLE EXCHANGE
		available for a period of 4 months not oftener than once in three years making a maximum of £600 per adult and £300 per child every three years plus allowance for return fares.
	2. Switzerland, Sweden, Portugal, and Belgium and their possessions except Portuguese India.	£75 per adult and £35 per minor to be deducted from the unit of £600 per adult and £300 per child every three years for countries in item (1). This amount of £75 is to cover travel in all or any of the countries in category (2) and £75 will not be available for each country separately.
	3. The Continent of America, Philippine Islands, Japan and Germany.	Remittance can only be made with the prior approval of the Reserve Bank which will fix the limit.
	4. Iraq, Iran, Saudi Arabia, Ceylon, Burma, Malaya, and the Dutch East Indies.	Rs. 2000/- per adult and Rs. 1000/- per child per annum plus allowance for return fares (This is in addition to the £600 unit laid down in (1) above).

TYPE OF TRAVELLER	COUNTRY TO WHICH TRAVELLING	PERMISSIBLE EXCHANGE
B. STERLING AREA NATIONALS	1. Countries in the sterling area.	Leave salaries and current income.
	2. The continent of America, Philippine Islands, Japan and Germany.	May only be made with the prior approval of the Reserve Bank of India.
	3. Iran, Saudi Arabia and Dutch East Indies.	Rs. 2000/- per adult and Rs. 1000/- per child per annum.
	4. All other countries.	£75 per adult and £35 per child per annum (This allowance may be drawn for any country or countries but must not exceed £75 in all in the case of an adult and £35 in all in the case of a child).
C. OTHER FOREIGN NATIONALS	To all countries inside the sterling area or to the traveller's country of domicile.	Rs. 5000/- per adult and Rs. 2000/- per child in the currency of a country in the sterling area or in the traveller's country of domicile. In addition the remittances of their leave salaries less the amount stated above may be made during the period of their stay outside India.

II. Business Journeys—

Applications for journeys on business grounds must be referred to the Reserve Bank of India.

III. Travel for Reasons of Health—

Applications for journeys on medical grounds both by Indian nationals and nationals of the sterling area must be referred to the Reserve Bank. If the applicant is proceeding to a country in the sterling area, the application must be supported by a certificate from the Presidency Surgeon that the illness is sufficiently serious to justify treatment outside India. If the applicant wishes to proceed outside the sterling area, a certificate signed by the Surgeon General that the necessary medical treatment is not available either in India or in any other country in the sterling area must be submitted. All sales of foreign currencies to travellers are required to be entered on the relative passport by the authorised dealers.

4.—Correspondence Courses

Correspondence courses do not require the prior approval of the Reserve Bank provided the sum involved does not exceed Rs. 200/- per annum. The following details should be furnished on the application form:

(i) detailed description of course and its duration,
(ii) full name and address of the beneficiary,
(iii) fees payable.

5.—Subscription to Foreign Magazines and Purchase of Books

Subscriptions to foreign magazines and for purchase of books do not require the prior approval of the Reserve Bank. The following particulars should be stated on the application form:

(i) name and address of the beneficiary,
(ii) brief description of books and magazines,
(iii) period for which the subscription is being paid.

6.—Subscriptions to Bona Fide Clubs, Scientific, Technical and Educational Institutions

Subscriptions to *bona fide* clubs, scientific, technical and educational institutions do not require the prior approval of the Reserve Bank provided the sum involved does not exceed Rs. 200/- per annum. The following details should be furnished on the application form:

(*i*) name and situation of the club or the institution,
(*ii*) subscription payable,
(*iii*) period for which subscription is valid.

7.—Purchase of Foreign Newspaper and Magazine Articles

Purchases of foreign newspaper and magazine articles do not require the prior approval of the Reserve Bank provided purchases are *bona fide* properties of Indian newspapers or magazines. The following particulars should be furnished on the application form:

(*i*) name and address of the beneficiary,
(*ii*) type of article,
(*iii*) whether payment is a single one or recurring.

Applications to purchase foreign currencies to effect remittances are to be made on the undernoted forms which are to be disposed of in accordance with the remarks made against each item:

CURRENCY	REMITTANCE DESIRED COUNTRY TO WHICH	FORM
Sterling or other sterling area currencies excluding Indian, Burma and Ceylon rupees.	Sterling area.	Form A (At the close of business each day these forms are to be submitted to the Reserve Bank on Form D3 Return).
Burma and Ceylon rupees.	Burma and Ceylon respectively.	Form A7 to be submitted to the Reserve Bank as above.

CURRENCY	REMITTANCE DESIRED COUNTRY TO WHICH	FORM
Sterling.	Other countries excluding the sterling area.	Form S.A.1 (At the end of each day they are listed on form D1 and submitted to the Reserve Bank).
Other Foreign Currency	Country of the currency.	Form A submitted to the Reserve Bank as above.

Where remittances are desired in rupees by effecting transfers to the rupee non-resident account maintained in India, Form A 7 is required to be completed. These forms are listed on Form D 4 and submitted to the Reserve Bank in the usual manner.

Purchase of Foreign Currency

1. *Exports.*—Under the present regulation the export of any goods from India to all countries with the exception of Afghanistan, Nepal, Tibet, Portuguese and French India and Pakistan is not permitted unless a declaration has been given that the foreign exchange representing the full export value of the goods has been or will be disposed of in a manner and within a period approved by the Reserve Bank of India. Declarations should be made by exporters on Form G.R.1, G.R.2 or Form G.R.3 indicating therein the method by which payment is being received. Except in the case of those wishing to export under Form G.R.3 in the manner indicated in a subsequent paragraph all shipping documents covering exports must be passed through the medium of a bank authorised to deal in foreign exchange and the name of the bank must be stated on the G.R. Form.

The methods by which payment for exports from India may be received are set out below:

(*a*) Goods invoiced in permitted foreign currency and payment received through a bank in India by (*i*) negotiating or sending for collection bills and/or documents drawn in ________ (state currency)

(*ii*) remittance in ________ (state foreign currency)

(*b*) Goods invoiced in rupees and payment received through a bank in India by (*i*) negotiating or sending for collection bills and/or documents drawn in rupees ; (*ii*) remittance in rupees.

(*c*) Goods invoiced in sterling and payments received through a bank in India by negotiation of a sterling bill on London drawn under a credit registered with the Bank of England on Form E2 under No.

(state Bank of England No.)

providing for reimbursement by a sale of foreign currency or by transfer from the permitted sterling account in the United Kingdom.

(*d*) Goods invoiced in sterling and payment received through a bank in India by (*i*) negotiating/sending for collection bills/shipping documents drawn in sterling on the country of destination of goods, payment to be received in sterling from the permitted sterling account in the United Kingdom ; (*ii*) remittance in sterling, the sterling being received from the permitted sterling account in the United Kingdom.

(*e*) Goods invoiced in sterling and payment received through a bank in India by

(*i*) negotiating / sending for collection bills / shipping documents drawn in sterling on

(Mention name) (of sterling area country concerned)

a sterling area country other than the U.K. providing for reimbursement by transfer from the permitted sterling account in the United Kingdom.

Forms G.R. 1 and 2 should be completed by exporters in quadruplicate and disposed of as under:

(*a*) The first copy will be submitted to the customs authorities along with the shipping bill.

(*b*) The second, third and fourth copies will be submitted to the authorised dealer in foreign exchange through whom the bill is negotiated or collected or through whom payment for the shipment has been or is being received,

along with the shipping documents. An extra copy of the shipper's invoice must be attached to the duplicate G.R. Form for submission to the Reserve Bank by the authorised dealer, where shipments to non-sterling area countries are financed by bills drawn in sterling on the U.K. The third and fourth copies of the form are attached to the drafts for submission to the Bank of England. In other cases these copies are retained by the authorised dealer for submission to the Reserve Bank as and when proceeds are received.

Form G.R.3 is meant to cover the transactions of those firms whose practice is not to finance their exports through the medium of banks but who retain the proceeds of the exports with branches overseas and utilise the funds for the purchase of goods for imports into India. The customs authorities will not accept declarations on Form G.R.3 unless under specific instructions from the Reserve Bank of India. Form G.R.3 will be completed in triplicate, the first copy being submitted to the Customs along with the shipping bill. The second copy together with a copy of shipper's invoice will be submitted to the Reserve Bank of India direct stating the foreign exchange proceeds which are proposed to be received in India and the third copy retained and submitted when proceeds are realised in accordance with the arrangements made by the Reserve Bank.

Exports by Parcel Post.—In case of exports by Parcel Post, declaration is to be made on a form P.P. This form is completed in triplicate, the original of which before submission to the Postal Authorities is required to be countersigned by an authorised dealer. Authorised dealers will countersign the forms P.P. on the strength of the relative invoices, bills etc., except parcels containing jewellery and precious stones which require valuation by the Customs authorities. The duplicate and triplicate of the P.P. are submitted to the authorised dealer for submission to the Reserve Bank in the usual manner. Purchases by authorised dealers of foreign currencies covering export may be made freely provided the shipping documents are accompanied by the appropriate G.R. Form.

Miscellaneous Purchases.—Purchases of T.T's, cheques, dividend warrants, clean bills etc. drawn in sterling or sterling area

currencies from residents in the sterling area may be made by authorised dealers up to £1500 or the equivalent thereof. It is the policy of the Government of India to exercise control over fresh investment in India by other countries in the sterling area. It is, therefore, necessary for an authorised dealer to obtain the prior permission of the Reserve Bank,

(*a*) before making individual purchases of sterling or other sterling area currencies in excess of £1500 or the equivalent thereof, other than the purchases against export and purchases of sterling from bank branches or correspondents for the purpose of laying down rupee funds in their accounts ;

(*b*) before making rupee payments from the accounts of the sterling area bank branches or correspondents including London offices in excess of Rs. 30,000. Applications to purchase sterling or sterling area currencies in excess of £1500 or equivalent thereof should be made on Form C giving full particulars of the remitter in the sterling area country, the name of the bank from which the remittance is received and the purpose of the remittance and the purchase can only be made when approved by the Reserve Bank.

At the close of business each day authorised dealers are required to submit a return of their purchases of sterling or sterling area currencies on Form D5.

Currency Notes and Coins Bullion.—In exercise of their general authority to deal in foreign exchange, authorised dealers are permitted to deal in foreign currency notes and coin in accordance with the regulations laid down by the Reserve Bank. In addition, certain established firms of money-changers the size of whose dealings appears to justify the granting of a licence have been authorised to deal in foreign currency notes and coin.

In exercise of the powers conferred by the F.E.R.A., the Central Government has prohibited the importation either by land or sea, any currency notes or bank notes (whether in circulation or unissued) other than currency notes of the Government of India or of any Indian State, Reserve Bank of India notes and notes which are legal tender in Burma, Ceylon, Iran and Afghanisthan unless generally or specially permitted by the Central Government

or the Reserve Bank of India. In exercise of the powers thus granted, the Reserve Bank of India has given general permission to import Bank of England notes up to £5 to any one passenger not being an officer or member of the crew of a ship or air vessel. On arrival the passenger is to make a declaration on Form A or Form B to the customs authorities of the total amount of notes brought in ; Form A is for the use of transit passenger while Form B is for the passenger disembarking at a port in India. This general permission does not apply to passengers arriving from (*i*) Portuguese territories in India, (*ii*) Iraq, (*iii*) Arabia, (*iv*) Iran, (*v*) Ports situated in the Persian Gulf. The import of Bank of England notes from these areas is totally prohibited. Authorised dealers may buy Bank of England notes provided the application is supported by the appropriate customs forms or has been approved by the Reserve Bank of India. The Reserve Bank of India has issued a general permission authorising the import of currency notes other than Bank of England notes without limit provided they are declared to the customs authorities by the holder on arrival. In the case of passengers declarations must be made on Form BX and in the case of members of ships' crew on Form MCX. Transit passengers are to declare on Form A whatever the currency is. This general permission does not apply to Rouble notes the import of which is totally prohibited.

Foreign currency and bank notes may be purchased from any person holding the Declaration Form A, B, BX, MC or MCX duly stamped by the customs authorities at the port of arrival, by any dealers in foreign exchange or licensed money-changer. Any forms bearing the stamp and signature of the Reserve Bank of India may be accepted even though no customs stamp has been affixed, but in no case should a form covering Bank of England notes in excess of the permitted limits be accepted unless it bears the stamp and signature of the Reserve Bank. When purchasing the authorised dealer and money-changer must enter in the appropriate column on the reverse of the form the amount purchased by them under their stamp and signatures and retain the forms when the currency notes declared thereon have all been cashed.

Authorised dealers may dispose of surplus Bank of England notes by sales to other authorised dealers or by export to their correspondents in the United Kingdom after obtaining an export

licence from the Reserve Bank. Authorised money-changers may dispose of surplus sterling notes by sale to authorised dealers after obtaining the approval of the Reserve Bank.

Authorised dealers may sell Bank of England notes up to £5 per head to intending travellers to the United Kingdom and to other ports of the sterling area. Such sales should be entered by authorised dealers in the travellers' passports. U.S. Dollar notes may also be purchased by travellers provided such purchases are approved by the Reserve Bank of India. Applications should be made on Form A and should be submitted through an authorised dealer. An authorised dealer should enter such sales in the passport.

In pursuance of subsection (2) of Section 8 of the F.E.R.A., the Reserve Bank of India has given general permission to (1) any person to take or send out of India (*a*) to any destination currency notes of the Government of India or Reserve Bank of India notes or Indian coin not exceeding Rs. 270 in value or foreign currency notes not exceeding Rs. 270 in value in any one month ; (*b*) to French territories in India, Portuguese territories in India, Nepal, Tibet, Pakistan currency notes of the Government of India, Reserve Bank of India notes and Indian coin and other notes and coin which are the currency of the country or territory to which they are being taken or sent without limit ; (*c*) to Afghanisthan, currency notes of the Government of India, Reserve Bank of India notes and Indian coin not exceeding Rs. 3,000 in any one month and other notes and coin which are the currency of the country or territory to which they are being taken or sent without limit.

Bullion.—In exercise of the powers conferred by the F.E.R.A. 1947, the Central Government have prohibited except with the general or special permission of the Reserve Bank of India any person from bringing or sending into India from any place outside India (*a*) any gold coin, gold, (*b*) any silver bullion, any silver, silver sheets or plates which have undergone no process of manufacture subsequent to rolling or any uncurrent silver coin.

Export of gold and silver is also prohibited except with the permission of the Reserve Bank.

Export of Jewellery.—Exports of diamonds and precious and semi-precious stones and articles of jewellery containing such

stones are prohibited except with the special and general permission of the Reserve Bank of India. Exports of such articles require permits from the Export Trade Controller in addition to the general or special permit from the Reserve Bank of India.

Acquisition by the Central Government of Foreign Exchange.—In exercise of the powers conferred by Section 9 of the F.E.R.A., 1947, the Central Government has directed that all persons who are owners or become the owners of the U.S. Dollars and/or Philippine Pesos are required to sell them within one month to authorised dealers being persons authorised by the Reserve Bank for that purpose against payment in rupees at the rate for the time being authorised by the Reserve Bank. This order does not apply to U.S. Dollars and/or Philippine Pesos held by authorised dealers within the scope of their authority or no persons authorised by the Reserve Bank to hold the above foreign exchange for business or other purposes. The Central Government have powers under this section to acquire any other foreign exchange in the above manner.

Export and Transfer of Securities: Foreign Securities

In exercise of the powers conferred by Section 13 of the Foreign Exchange Regulation Act 1947, the Central Government has directed that no person except with the general and special permission of the Reserve Bank shall (*a*) take or send any security to any place outside India, (*b*) transfer any security or create or transfer any interest in a security to or in favour of a person resident outside India. Purchase of foreign securities except with the general or special permission of the Reserve Bank is prohibited. Authorised dealers who wish to purchase fresh securities in place of the securities which have matured must also take permission from the Reserve Bank.

In exercise of the powers conferred by Section 19 of the F.E.R.A., 1947, the Central Government has directed that all persons who are owners or become owners of any securities in respect of which the principal, interest or dividend is or are payable in the currency of any country or territory outside India are

to make a return to the Reserve Bank of India on a form obtained from an office of the Reserve Bank giving, (*i*) name and address of the owner, (*ii*) description of security, (*iii*) whether the security is free or encumbered, (*iv*) the place in which and the name of the person with whom the security is deposited. The Central Government for the purpose of strengthening its foreign exchange position may, by notification in the official Gazette, acquire foreign securities by having them transferred to itself at a price not less than the market value of these securities.

RETURNS

In terms of the regulations authorised dealers are required to submit the following returns to the Reserve Bank of India:

I. Daily purchases of sterling and other sterling area currencies.
II. Daily sales of sterling and other sterling area currencies.
III. Weekly return covering purchases and sales of sterling.
IV. Daily purchases of U.S. Dollar.
V. Daily sales of U.S. Dollar.
VI. Weekly return covering purchases, sales of all foreign currencies other than sterling area currencies.
VII. Monthly return of the balances of all foreign currencies and securities held by authorised dealers.
VIII. Return of credit and debit balances of U.S. Dollar, Canadian Dollar, Philippine Pesos, Belgian monetary area, Portugal, Sweden, Switzerland currencies.

OTHER ACTIVITIES OF THE RESERVE BANK OF INDIA

The Bank has participated effectively in setting up institutions for the training of personnel required by the co-operative and commercial banks in the country. The Bank organized in 1952 an all-India training centre for co-operative personnel at Poona in conjunction with the Poona Co-operative Training College run by the Bombay Provincial Co-operative Institute. This centre is subsidised by the Reserve Bank and provides train-

ing for both officials and non-officials interested in the co-operative movement.

The Reserve Bank set up in July 1953 a Committee consisting of representatives of banks and other experts to frame a concrete scheme of starting a training college for the staff of commercial banks in the country and to make suggestions in respect of the preliminary measures to be taken in such matters as the framing of the syllabus, securing the teaching staff, etc. The Report of this Committee was submitted in January 1954 and in Sept. 1954 the College started functioning at Bombay. The entire administrative expenses of the College are borne by the Reserve Bank.

To assist it in running the College, the Reserve Bank has constituted an Advisory Council. Four courses of training, each of eight weeks' duration, have been completed and each course was attended by 24 trainees deputed by commercial banks. The curriculum is so designed as to be of maximum advantage to the branch manager of the average-sized branch of a commercial bank. The endeavour has been to promote a realistic interest in banking as a worthwhile career and to encourage a sound sense of confidence backed by knowledge and understanding. The facilities afforded by the College and their beneficial effects on individual trainees have been increasingly appreciated by banks (Source: Reports of the Central Board of Directors of the Reserve Bank of India for 1954 and 1955). The College has up to 1960 conducted 31 courses at which 772 candidates from different banks received training. In 1960 the College has also introduced another course, *viz.*, intermediate course for the training of Accountants and officers at comparable level.

Reserve Bank of India and the Money Market

Technically, the Reserve Bank of India is fully equipped with all necessary weapons for the control of currency and credit. It has the sole right to issue notes whereby it is enabled to determine, to a large extent, the total supply of money in the market. It is in an advantageous position in this respect, inasmuch as in our country the cheque habit being undeveloped, these instruments

do not affect the monetary supply in the market in competition with the Bank notes, in so much degree as is found in other countries like the U.S.A. and England. But now the tide is turned, because the cheques are gaining popularity in our country day by day. Moreover, it keeps the statutory deposits of the scheduled banks and may also keep the balances of other non-scheduled banks on fulfilment of certain conditions. As a result the Reserve Bank can exercise much control over the cash reserves of these banks and through those reserves, over their ultimate lending policy. Besides this, the funds of the Government are at the disposal of the Reserve Bank of India and contribute to its resources. All these factors taken together place the Reserve Bank in a key position wherefrom it is easy to control the currency and credit system of the country.

But in view of the cheap money policy adopted by the Government soon after its inauguration, and its continuance for a long time, the extent and effectiveness of the control of the Reserve Bank of India over the currency and credit of the country could not be accurately gauged. It will not be wrong to say that the efficacy of the weapons of the Reserve Bank has so far not been put to the test. But we should not be surprised if some of these weapons are found wanting having regard to the loosely-knit economy of the country and the unorganised nature of its money market. It is an admitted fact that unless the money market is well developed and properly organised, the Central Bank of a country cannot make its influence felt. While discussing the essential features of the Indian money market, its glaring weaknesses have been revealed. So we cannot blame the Reserve Bank so much for lack of any definiteness in its policy hitherto adopted. It had to experiment slowly with the instruments of control and weigh each reaction on the money market with precision.

The position of the Imperial Bank of India (now the State Bank of India) is an anomaly in the Indian money market. It is called upon to discharge some of the central banking functions in places where the Reserve Bank of India has no branch of its own, including the management of the Treasury affairs, keeping of Government accounts etc, while it competes with other joint-stock banks in banking business. This anomaly is partly responsible

for weakening the influence of the Reserve Bank in the money market. But still there is no sufficient reason to treat this anomaly as a serious impediment to the establishment of control by the Reserve Bank over the money market.

Again the influence of exchange banks is predominant in the money market. Possessed of enormous resources and having branches spread all over the world, these exchange banks may neutralise the effect of any policy pursued by the Reserve Bank. So the Reserve Bank has to contend with such powerful counteracting factors before it is in a position to control the money market. But there is no possibility of opposition from exchange banks, as India is now in need of enlarging credit rather than contracting credit. Moreover, unyoked as India is from the fetters of an alien Government, the Reserve Bank of India is no longer to face this difficulty, which it experienced before in carrying out its policy in the face of opposition from the exchange banks. It is now free to pursue its own policy to promote the interests of the country.

The Reserve Bank's influence in the money market was so long incomplete, as it had no power over the indigenous bankers, who supply more than 90% of rural credit. If such an important sector of the credit-financing agency remains outside the influence of the Reserve Bank, its control will naturally be weak. The linking of the indigenous banks to the Reserve Bank is a problem which must have to be satisfactorily tackled in order to control the money market in an effective manner. The scheme advanced by the Reserve Bank to the indigenous bankers might be commendable in respect of its conformity to the traditional central banking principles ; but it is considered in certain quarters as too revolutionary a scheme, which, in the existing circumstances, could not find favour with those indigenous bankers inasmuch as it sought to overthrow at a single stroke the very basis of indigenous banking. So instead of asking the indigenous bankers to wind up their trading business all at once, it would, they consider, be more practical for the Reserve Bank to ask them to do it by and by. Anyway, the Reserve Bank must have to bring the indigenous bankers within the sphere of its influence to control the money market and the matter is receiving its active consideration.

So long the discount policy of the Reserve Bank was practically ineffective due to paucity of commercial bills. It has been observed before, how the discount policy of the Central Bank influences the money market. The *modus operandi* of the Bank rate has been discussed earlier to show its influence in this direction. It is well understood that unless the discount policy is forged, the money market will be left to the mercy of diverse forces moving in different directions. So the Reserve Bank of India should devise ways and means for making the Bank rate effective as its influence so far on the money market was not felt at all. There was no correlation in our country between the Bank rate and the market rate. The Imperial Bank of India (now the State Bank of India), by virtue of its predominant position in the money market, adopts its own rate. Unless the Bank rate could influence the market rate, the supremacy of the Reserve Bank will be weakened. Much work is to be done in this connection to improve the present state of affairs. It is often contended that because of the unorganised nature of India's money market the Reserve Bank of India can wield but little influence. But experiences in South Africa and Australia show how it was possible for the Central Banks of the respective countries, in spite of the handicap of an undeveloped money market, to steer clear of the difficulties of the deflation following the last war and of the uncertainties of the depression period in 1929. The Canadian Banking and Currency Commission observes, "The Commonwealth Bank was instrumental in mobilising the gold reserves of the country and their judicious employment with a view to tide the country over a period when Australia's ability to provide and transfer the services of overseas debt was seriously in question." In that context the Reserve Bank of India also made in certain cases its influence felt, though it was not possible to measure the exact extent of its control over the money market. It could mitigate the seasonal stringency of the money market as will be evident from the gradual narrowing down of the disparities between different money rates like hundi rates, bazar rates in Calcutta and Bombay.

The Reserve Bank of India has already evolved a scheme for the creation of a bill market, and is also trying hard to develop a wider Treasury bill market with the co-operation of the Indian

joint-stock banks. One of the defects of the Treasury bill market in India is the absence of any material support from outside the banks. The Reserve Bank of India will have to find out ways for interesting outside agencies in the Treasury bills, if the scope of this market is to be widened. There is a strong feeling in the money market against discounting of Treasury bills. The Reserve Bank must create such a feeling in the market that Treasury bills are treated just like cash, and not as investments. If the Reserve Bank can promote such a market in Treasury bills, it will, by swelling the floating debt in the market, reduce the cost of Government borrowings and enable the Reserve Bank to exercise greater control in the money market by discounting such bills.

The Reserve Bank has helped to improve the tone of the money market by encouraging the development of sound banking practices. By advice and inspection, the Reserve Bank of India is guiding Indian banking on sound lines, and thereby its influence over the money market is going to be firmly *established.*

During the period covered by 1946-47, the general lack of confidence engendered by the political developments produced a situation in which investment demand was lacking and there were some withdrawals of funds from banks which necessitated the selling of securities by banks to replenish their cash resources with a view to meeting any possible contingencies. This lack of confidence being the result of the uncertainty created by political and other causes, its effect on security prices could not be counteracted entirely by action confined to the monetary sphere only. The Reserve Bank in this situation came to the support of the market on a substantial scale in order to maintain security prices and to stabilise the banking and financial structure generally at levels where there was reasonable prospect of holding. The support had a steadying influence on the market and on the banking system and was a contributory factor for the stability of security prices which took place towards the end of the financial year.

The Reserve Bank of India made the first official mention of open market operations in the Annual Report for 1946-47. That year saw two distinct movements in the security market. In the first four months up to August there was a boom, especially in

July and August, when the yield of 3% (63-66) bonds fell in the course of one month from 2.71% to 2.57%. The Reserve Bank tried to stem the sharpness of the fall by selling large amounts of securities. The total investments of the Bank which were Rs. 30.37 crores on 28th June fell in the course of one month to Rs. 17.10 crores and then on August 2nd to Rs. 7.19 crores, a fall of Rs. 23.18 crores in the course of five weeks. From the middle of August, there was a serious set-back caused by the communal disturbances all over the country. The yield rose to 2.67 in September at which level it remained more or less steady till the end of November. From December, there took place a serious decline in security prices. The Bank began to buy securities and its investments increased from Rs. 16.50 crores in November to Rs. 40.42 crores on 27th December. The subsequent annual reports mentioned the fact of continuous official support of the security market. "The Bank's purchases of securities were particularly large during the years 1948-49 and 1950-51, the latter being the period of the Korean war boom. This policy of comparatively free purchases of securities by the Bank was modified in mid-November 1951. The revised policy was in operation for about five years during which the Bank was able to make net sales of securities of about Rs. 50 crores as against net purchases aggregating a little over Rs. 200 crores during the years 1948-51. From November 1956, however, the Bank began to offer discriminating support to the gilt-edged market to ease the acute stringency in the money market. Apart from purchases or sales, the Bank engages extensively in 'switch' operations, *i.e.*, purchase of one loan against sale of another and *vice versa* to maintain an orderly pattern of yields and to cater to the varying requirements of investors with respect to maturity distribution policy since the middle of 1957. However, the emphasis has been shifted to sales and there has been a considerable excess of the Bank's sales over purchases of securities" (The Reserve Bank of India—Functions and Working).

The Reserve Bank of India has also succeeded in insulating the economy of the country from the effects of the purchase or sale of sterling and from the impact of variations in its holdings of foreign assets as will be evident from the following table and has thus been able to exercise a steady influence on the money market:

Changes in the Volume of Foreign Assets and Money in Circulation in India

(In lakhs of rupees)

Period	Net purchase (+) or Sales (−) of Sterling.	Changes in the foreign assets of the R.B. (a).	Changes of the total volume of notes in circulation plus deposits of bank.	Changes in the volume of securities held by the R.B. (b).
April to September, 1946	−39 71	−54·49	+51·49	−18·94
October, 1946 to March, 1947	−47·78	−53·13	+12·32	+42·07
October, 1947 to April, 1948	+0·48	−93·65	−9·19	+27·48
October, 1947 to March, 1948	+112·42	+4·74	+171·04	+31·15
April to September, 1948	−25·74	−419·51	−102·54	+258·03

(a) Includes the volume of foreign securities held in the Issue Department and balances held abroad of the Banking Department

(b) Includes rupee securities in the Issue Department plus investments of the Banking Department.

Section 21 of the Banking Companies Act, 1949 gives some powers to the Reserve Bank of India for selective control of credit. The Reserve Bank is thus empowered not only to control the volume of credit but also to determine the ultimate use of money by controlling the purposes for which banks make advances. The Reserve Bank reserves the right to give directions to banks as to the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances.

The Reserve Bank took various measures to ensure that the pattern of bank credit conformed to the general economic policy and to the needs of the situation in the country. After the devaluation of the Indian rupee in September 1949 a resurgence of speculative activity was feared. Banks were, therefore, advised to restrict their advances to genuine trade requirements and not to grant any accommodation for speculative purposes. They were also required to submit to the Reserve Bank a daily return of all credit limits sanctioned by them in excess of Rs. 1 lakh. When

after a scrutiny of these returns, the Reserve Bank was of the opinion that certain advances were of an undesirable character, the banks concerned were advised to effect a recall. In March 1950, all scheduled banks were requested to furnish the Reserve Bank with a statement showing their advances against bullion and commodities which were the subject of speculative interest. These returns enabled the Reserve Bank to judge the extent to which bank finance was being utilised for speculative building up of stocks and to take appropriate measures to remedy the position. Scheduled banks operating in the Calcutta area were, for instance, requested in 1950 to recall within a specified time all their advances for the purchase of raw jute made to parties other than mills and balers, and to refrain from granting any fresh advances till the supply position of raw jute improved. This facilitated the flow of raw jute to the mills and as the supply position improved in 1951, the restrictions on jute advances were withdrawn. With a view to bringing bank accommodation for financing trade in important commodities, as also in shares and debentures, under close observation, the Reserve Bank issued on April 4, 1956 a circular to all scheduled banks calling for fortnightly returns of advances. The monthly statements of advances, which were being received prior to this circular, revealed that banks' advances against paddy and rice had shown an unhealthy increase over the year to March 1956. Therefore, on May 17, 1956, the Bank issued a circular letter to all scheduled banks impressing upon them the necessity of refraining from excessive lending against commodities and also from assisting speculative hoarding of stocks. They were directed not to increase any credit limits in respect of advances against the security of paddy and rice or sanction any fresh credit limit in excess of Rs. 50,000 in respect of such advances, and to increase the existing margin in respect of the limits and advances by an amount not less than 10 per cent of the value of these commodities. Scheduled banks were further requested to endeavour to reduce their aggregate advances against paddy and rice to a level not exceeding 25 per cent above that prevailing at the corresponding time in the previous year. These restrictions were withdrawn in November 1956 and reimposed on February 9, 1957. A directive containing certain restrictions on cotton manufactures was also issued and withdrawn after a relatively short period of its working. Thereafter, the Bank issued a series

of directives imposing restrictions on advances against various types of commodities according as the circumstances demanded and modified them from time to time to meet the changing situations. Thus, to curb speculative dealings in shares, the Bank directed the scheduled banks to keep a margin of 50% on advances against equity shares and later reduced the margin to 40% when the situation improved. The control on advances against wheat and sugar was withdrawn. The Bank also introduced in March 1960 additional reserve requirement on the part of scheduled banks. But the net effect of the additional reserve requirement on the bank credit was not appreciable. "The situation indicated the need for limiting the banks' access to the Reserve Bank on some basis. The course open to the Bank for this purpose was to fix ceilings for borrowings by banks or to raise the cost of such borrowings or to adopt a combination of both methods. It was considered best in the circumstances to introduce a system of slab rates under which scheduled banks' access to the Bank was regulated under a three-tied structure of rates related to the extent of borrowing. Accordingly, a new set of general credit measures was announced on September 21, 1960. Effective October 1960, each scheduled bank was assigned for purposes of its borrowing at the Bank rate, a quota for each quarter, equal to half of the average amount of statutory reserves required to be maintained by it during the previous quarter in terms of section 42(1) of the Reserve Bank of India Act. Any borrowing over this level up to 200% of the quota would bear a rate of 1% above the Bank rate ; borrowings in excess of 200% of the quota would bear a rate of 2% above the Bank rate. The Bank also directed that, with effect from October 1, all scheduled banks should adhere to a minimum lending rate of 5% on all advances except to those to other banks and bank employees ; in addition all banks were required to raise their average lending rate at least by ½%, the base period for comparison being the year ended June 30, 1960. This measure was adopted to ensure that the higher cost of borrowing from the Reserve Bank was transmitted to the ultimate borrower so as to mitigate the demand for bank credit. Simultaneously, with a view to preventing possible circumvention by banks of the directive regarding higher rates on lending by offering higher rates on short-term deposits, the Banks also fixed a ceiling of 2% in respect of deposits accepted by scheduled

banks from the public repayable on notice of or on the expiry of a period not exceeding 21 days. The system of slab rates combines the features of direct limitation on borrowing and raising the cost of borrowing. It provided a technique whereby the objectives of credit restraint could be attained without too large an adjustment in Government security prices. While this move towards raising the cost of credit was taken with a view to imposing a degree of discipline on both banks and their borrowers, it was not the intention of the Bank to restrict the availability of credit for the legitimate needs of industry and trade. In fact the Bank broadened the credit base by removing the ceilings on advances under the Bill Market Scheme. Further with the approach of the busy season of 1960-61 and in the face of a slackening in the rate of growth of deposits, the Bank withdrew the additional reserve requirement in two stages, on November 11, the directive issued on May 5, 1960 regarding the maintenance of additional statutory reserves was relaxed. Further impounding of the increase in liabilities over the level as on November 11 was suspended ; also about half of the reserves already impounded were released by a reduction in the additional reserve requirement to 25% of the increase since March 11, 1960. The reserves thus released amounted to Rs. 13 crores. Subsequently, the additional reserve requirement was revoked altogether with effect from January 13, 1961 releasing a further amount of Rs. 13 crores. Effective February 22, 1961, the peg on the 21 days' deposit rate was also withdrawn to enable banks to readjust the pattern of interest rates in the context of a slowing down of the rate of growth of deposits. The selective credit controls worked with a larger measure of success, since they were operated in conjunction with general quantitative controls. The compliance by banks with the selective credit control directives continued to be generally satisfactory''.

(Source: Report of the Reserve Bank's Central Board of Directors for the year ended June 30, 1961)

Transformation of the Imperial Bank of India into the State Bank of India

The Imperial Bank of India was established in the year 1921 by a special act called the Imperial Bank of India Act, 1920.

After the inauguration of the Reserve Bank of India, the Imperial Bank of India Act was amended in various respects in the year 1934. Originally, the Imperial Bank of India was largely manned by Europeans and pursued a conservative banking policy with the result that the legitimate claims of Indian trade and commerce for banking facilities were not adequately fulfilled. At the outset and for a long time thereafter, it was freely charged with discrimination against Indian firms and business houses vis-a-vis the European firms and business houses. The bank was also accused of an unfair competition with the Indian banks. In order that the bank might play a more useful role in the sphere of Indian banking the Central Banking Enquiry Committee made the following important recommendations:

(*a*) The bank should discount more freely bills of the indigenous bankers whom it should employ as its collecting agents.

(*b*) It should liberalise its policy of advances against stocks in godowns.

(*c*) It should provide finance to industries on the lines of joint-stock banks in Germany.

(*d*) It should take the lead in financing India's foreign trade.

Later, there was a progressive Indianisation of the staff of the bank and a considerable liberalisation of its policy in respect of advances and investments. Gradually, it held a key position in the Indian money market and played an important role in facilitating the development of trade, industry and other economic activities in the country. After our country attained independence, there was a cry for the nationalisation of this bank. But such a step was considered premature at that time. The Rural Banking Enquiry Committee which was appointed some time in 1950 made, inter alia, certain recommendations regarding the future role of the Imperial Bank of India in the banking and treasury set-up which were implemented.

Later, the Committee of Direction of the Rural Credit Survey recommended the setting up of the State Bank of India as one strong, integrated, State-partnered commercial banking institution with an effective machinery of branches spread over the whole country for stimulating banking development by providing vastly

extended remittance facilities for co-operative and other banks and by following a policy which can be in effective consonance with the national policies. Accordingly, the Government of India announced their intention to set up the State Bank of India by transferring to it the undertaking of the Imperial Bank of India. This was followed up by the introduction of the necessary legislation in Parliament and on the 8th May, 1955 the State Bank of India Bill received the President's assent. On the 1st July, 1955 the State Bank of India came into being and took over only the offices in India of the Imperial Bank of India, since the State Bank of India (Amendment) Ordinance was passed to allow the Imperial Bank of India to continue as a legal entity until arrangements could be effected for its foreign branches to be taken over by the State Bank of India according to the law in respective countries. Thus the transformation of the Imperial Bank of India—as it is the result of the amalgamation of the 3 Presidency banks in 1921—into the State Bank of India marks a new chapter in the history of Indian banking. The State Bank of India will continue to undertake commercial banking business and recognise financial principles and will provide credit to industry, trade and commerce. Suitable modifications and alterations have also been made in its structure to adapt it, consistently with sound banking principles, to its new role in the field of rural finance. One of the important objectives of the State Bank of India is to establish not less than 400 additional branches within 5 years or such extended period as the Central Government may specify, particularly at district headquarters and sub-divisional centres with a view to providing considerably larger remittance and other banking facilities to co-operative and other banks and to mobilising rural savings. The State Bank of India will function as the agent of the Reserve Bank of India as the Imperial Bank of India did, in all places in India where there is no branch of the Banking Department of the Reserve Bank of India and where there is a branch of the State Bank of India, or of its subsidiaries and is empowered to transact any business and perform any function entrusted to it as the agent of the Reserve Bank of India.

The State Bank of India has an authorised share capital of Rs. 20 crores and an issued share capital of Rs. 5.62 crores which has been allotted to the Reserve Bank of India in lieu of the shares

of the Imperial Bank of India transferred to it. The erstwhile shareholders of the Imperial Bank of India will receive compensation at the rate of Rs. 1,765/10/- for every fully paid-up share and Rs. 431/12/4 for a partly paid-up share, in Central Government securities and, at the option of the shareholders, in the form of State Bank of India shares up to a maximum of 200 shares. The Reserve Bank of India is holding about 55% of the issued share capital of the State Bank of India.

The State Bank of India is required to maintain a special Integration and Development Fund to be created out of (*i*) dividends payable to the Reserve Bank of India on such shares of the State Bank of India held by it as do not exceed 55% of the total issued capital; and (*ii*) such contributions as the Reserve Bank of India or the Central Government may make from time to time. The amount in the fund will be applied exclusively for meeting (*a*) losses in excess of such yearly sum as may be agreed upon between the Reserve Bank and the State Bank of India and attributable to the additional branches established in pursuance of the provisions of the State Bank of India Act; (*b*) Subsidies granted by the State Bank to a subsidiary bank with the approval of the Reserve Bank and (*c*) such other losses or expenditure as may be approved by the Central Government in consultation with the Reserve Bank of India.

Apart from the main contribution to the rural credit structure implicit in the large programme of branch expansion the State Bank's part in expanding rural credit may also be visualized in the purchases of debentures of land-mortgage banks or by making direct advances against agricultural produce or small-scale industries and generally in co-ordinating its activities with those of co-operative institutions in a variety of ways. With the expansion of its branches in the interior of districts, the bank has been able to assist in devising remedies for difficulties connected with the short-term finance to rural and small-scale industries. The bulk of the credit requirements of the village industries would have to be provided by the institutional agencies and the State Bank accordingly took up with the Reserve Bank of India the question of planning a co-ordinated scheme of extending credit to these industries.

Accordingly in 1956, the State Bank of India, in consultation

with the Reserve Bank of India and in collaboration with other institutional agencies, initiated a Pilot scheme at 9 of its branches. The experience gained by the Bank having been satisfactory, the scheme was extended to all its branches in 1959. In order to give positive encouragement to small industries the State Bank has liberalised its lending practices and procedures. The Bank charges small-scale industries at present on all-inclusive interest rate not exceeding 6 per cent. Important branches of the bank have been working as intensive centres for achieving better results particularly in regard to the co-ordination of its activities with those of other agencies in this field.

Another field in which the State Bank is breaking new ground is in providing medium term finance to industry. The Bank has made some headway in extending term credit to industrial concerns, including some medium term loans granted at London office for assisting the development of Indian shipping.

The bank has been lending its full support to the Central Warehousing Corporation and the State Warehousing Corporations. The bank has also taken a lead in evolving appropriate procedures for granting advances against warehouse receipts.

The bank has been subscribing in suitable lots to the debentures issued from time to time by the Central Co-operative land-mortgage banks and has thus been increasing the supply of long-term agricultural finance.

Integration of State-associated Banks

The All-India Rural Credit Survey Committee had recommended the amalgamation of the several State-owned and State-associated banks with the State Bank of India so as to create one strong, integrated, State-partnered commercial banking institution for the purpose of stimulating banking development in the country. Following a detailed examination of this recommendation and in deference to the wishes of the concerned banks, Government came to the conclusion that the objective of bringing about an integrated banking structure all over the country could as well be achieved by forming such of these banks as were willing, as subsidiaries of the State Bank of India. Accordingly, the State Bank of India (Subsidiary Banks) Act was passed in September 1959 enabling

the State Bank to take over the following eight State-owned and State-associated banks as its subsidiaries.

1. State Bank of Hyderabad
2. Bank of Jaipur
3. Bank of Indore
4. Bank of Bikaner
5. Travancore Bank
6. Bank of Patiala
7. State Bank of Saurashtra
8. Bank of Mysore.

All of the above banks have by now been taken over by the State Bank of India.

While the State Bank of India will be a majority holder of the share capital of each of these subsidiaries (except the three completely Government-owned banks in whose case the State Bank will hold the entire share capital) there is sufficient scope for private shareholders both as regards the ownership of capital as well as representation on the respective Boards of Directors. Each of these subsidiaries being autonomous, continues to maintain its individuality and independence in its day-to-day operations, while the State Bank of India has the general powers of control, supervision and direction. This will not, however, affect the character, the traditions or the business of any of these banks. In fact the object of taking them over is to import to them additional strength and stability so that they can play a more useful role in the country's economy. Their integration should also enable the State Bank of India to function as a more effective instrument of national policy.

According to the State Bank of India Act, 1955 the Central Board of the bank shall consist of the following, viz.—

(*a*) a Chairman and a Vice-Chairman to be appointed by the Central Government in consultation with the Reserve Bank and after consideration, except in the case of first appointments, of the recommendations made by the Central Board in that behalf ;

(*b*) not more than two managing directors, if any, appointed by the Central Board with the approval of the Central Government ;

(*c*) six directors to be elected in the prescribed manner by the shareholders other than the Reserve Bank whose names are entered in the various branch registers;

(*d*) eight directors to be nominated by the Central Government in consultation with the Reserve Bank to represent, as far as possible, territorial and economic matters and in such manner that not less than two of them have special knowledge of the working of co-operative institutions and of rural economy and the others have experience in commerce, industry, banking or finance ;

(*e*) one director to be nominated by the Central Government;

(*f*) one director to be nominated by the Reserve Bank.

The Chairman and the Vice-Chairman shall hold office for such term, not exceeding five years, as the Central Government may fix. The Managing Director shall likewise hold office for such term, not exceeding five years, as the Central Board or, in the case of the first two appointments, the Central Government may fix.

There shall also be constituted at each place where the State Bank has a local office, a Local Board. A Local Committee may be constituted by the Central Board for any area consisting of such number of members as it may determine.

Under the State Bank of India Act, 1955 the State Bank has been assigned enlarged functions, some of which are enumerated below:

(*i*) Advancing and lending money, and opening cash-credits upon the security of:

(*a*) stocks, funds and securities (other than immovable property) in which a trustee is authorised to invest trust money by any law for the time being in force in India or in any other country in which the State Bank has a branch ;

(*b*) debentures or other securities for money issued by or on behalf of a district board or a municipal board committee or, other local authority under the authority of any Central Act, Provincial Act or State Act or of any law for the time being in force in any other country in which the State Bank has a branch ;

(*c*) subject to such directions as may be issued by the Central Board, debentures of companies with limited liability whether registered in India or in such other country as the Central Government may approve in this behalf or shares and debentures of corporations established by or under any law for the time being in force in India other than companies with limited liability ;

(*d*) goods which, or the documents of title to which, are deposited with, or assigned to, the Bank as security for such advances, loans or credits ;

(*e*) goods which are hypothecated to the Bank as security for such advances, loans or credits, if so authorised by special directions of the Central Board ;

(*f*) subject to such directions as may be issued by the Central Board, book debts or other assets of any undertaking engaged in the financing of hire-purchase transactions which are hypothecated to the State Bank as security for such advances, etc.

(*g*) accepted bills of exchange and promissory notes endorsed by the payees and joint and several promissory notes of two or more persons or firms unconnected with each other in general partnership ; and

(*h*) fully paid shares of companies with limited liability, or immovable property or documents of title relating thereto as collateral security only where the original security is one of those specified in sub-clauses (*a*) to (*d*), and subject to such directions as may be issued by the Central Board where the original security is of the kind specified in sub-clauses (*e*), (*f*) and (*g*)

(*ii*) the selling and realisation of the proceeds of sale of any such promissory note, debentures, stock-receipts, bonds, annuities, stock-shares, securities or goods which or the documents of title to which have been deposited with or pledged, hypothecated, assigned or transferred to the bank as security for such advances, loans or credits, or which are held by the bank or over which the Bank is entitled to any lien or charge in respect of any such loan or advance or credit or any debt or claim of the Bank

and which have not been redeemed in due time in accordance with the terms and conditions, if any, of such deposit, pledge, hypothecation, assignment or transfer ;

(*iii*) advancing and lending money to Courts of Wards upon the security of estates in their charges or under their superintendence, and the realisation of such advances or loans and any interest due thereon provided that no such advance or loan shall be made without the previous sanction of the State Government concerned, and that the period for which any such advance or loan is made shall not exceed fifteen months in the case of advances or loans relating to the financing of agricultural operations, and six months in other cases ;

(*iv*) the drawing, accepting, discounting, buying and selling of bills of exchange and other negotiable securities ;

(*v*) the investing of the funds of the Bank in any of the securities specified in sub-clauses (*a*) to (*d*) of clause (*i*) and converting the same into money when required, and altering, converting and transposing such investments for or into others of the investments above specified ;

(*vi*) the making, issuing and circulating of letters of credit to order, or otherwise than to the bearer on demand ;

(*vii*) the buying and selling of gold and silver whether coined or uncoined ;

(*viii*) the receiving of deposits and keeping of cash accounts on such terms as may be agreed on ;

(*ix*) the acceptance of the charge of plate, jewels, title deeds or other valuable goods on such terms as may be agreed on ;

(*x*) the selling and realising of all property whether movable or immovable, which may in any way come into the possession of the Bank, in satisfaction or part satisfaction of any of its claims and the acquisition and holding of, and generally the dealing with, any right, title or interest in any property, movable or immovable, which may be the Bank's security for any loan or advance or may be connected with any such security ;

(*xi*) the transaction of pecuniary agency business on commission ; and the entering into contracts of indemnity,

suretyship or guarantee with specific security or otherwise ;

(*xii*) the administration of estates for any purpose whether as an executor, trustee or otherwise and the acting as agent on commission in the transaction of the following kinds of business:

(*a*) the buying, selling, transferring and taking charge of any securities or any shares in any public company ;

(*b*) the receiving of the proceeds, whether principal, interest or dividends, of any securities or shares ;

(*c*) the remittance of such proceeds by public or private bills of exchange, payable either in India or elsewhere ;

(*xiii*) the drawing of bills of exchange and the granting of letters of credit payable out of India ;

(*xiv*) the buying of bills of exchange payable out of India, at any usance not exceeding fifteen months in the case of bills relating to the financing of seasonal agricultural operation, or six months in other cases ;

(*xv*) the borrowing of money for the purposes of the Bank's business and the giving of security for money so borrowed by pledging assets or otherwise ;

(*xvi*) the subsidizing from time to time of the pension funds of the Presidency Banks, the Imperial Bank of India, and

(*xvii*) generally, the doing of all such matters and things as may be incidental or subsidiary to the transaction of the various kinds of business including foreign exchange business hereinbefore specified.

In addition to the above functions, the State Bank may, with the sanction of the Central Government, and shall, if so directed by the Central Government, in consultation with the Reserve Bank enter into negotiations for acquiring the business including the assets and liabilities of any banking institution. It is further authorised to lend money to some companies or co-operative societies for any period upon the security of all or any of their assets for the purpose of facilitating their winding up. It may also subscribe with the approval of the Reserve Bank to buy, acquire or hold and sell any shares in or the capital of any banking

institution and form or conduct any such banking institution as a subsidiary of the State Bank or in any other bank. By an amendment of section 39 of the Banking Companies Act, the State Bank of India is authorised to act as the liquidator of a banking company if such an application is made by the Reserve Bank of India.

"Only the future can unfold the full significance of the State Bank of India for the country's economic development ; a development which is intimately bound up, in both the public and the private sectors, with the Second Five Year Plan. The establishment of the State Bank coincides with a crucial stage in that development. Its potentialities for growth and expansion are far beyond those at any time open to its predecessor. So too are the opportunities it has for mobilising resources and, without deviating from its orbit, of influencing their utilisation in a manner consonant with the objectives of the Plan. That the role of the bank vis-a-vis the private sector of commerce and industry will be one of undiminished usefulness and importance is clear from the assurances given on behalf of the Government. Indeed, it may be expected that the importance of its role vis-a-vis both the sectors will, as time goes by, be greatly enhanced. With the programme of expansion enjoined on it and the framework of functions designed for it in the statute, there cannot be the least doubt that the State Bank will not merely continue to be the foremost commercial banking institution of the country, but will grow in size, stature and significance. Another aspect may be emphasized. The State Bank's charter is based on the axiom that there does not exist in essence, and need not obtain in fact, a contradiction between sound business principles on the one hand and the public interest on the other. The device already mentioned whereby the uneconomic part of the cost of branch expansion undertaken in the public interest is debited to a special fund provided by the State is only one of many examples of how a reconciliation can in practice be effected between the two sets of considerations involved. With mutual understanding, commonness of purpose and co-ordination of action—in other words with the fullest co-operation—between the Government of India, the Reserve Bank and the State Bank, there is little doubt that such a synthesis can be achieved and that the State Bank, complementing the functions of the Reserve Bank in an essential sphere, can emerge as a power-

ful instrument of public policy, including that of planned development, while at the same time maintaining the highest standards of commercial banking."

(Source: Reports the Central Board of Directors of the Reserve Bank of India for 1954 and 1956)

The performance of the State Bank of India during the subsequent years has amply justified the high hopes entertained about its potency. It has opened as many as 429 branches since July 1, 1955 as against the target of 400 branches. Of them, 352 branches were opened in rural and semi-urban areas with population of 30,000 or less. It has taken over 8 major State-associated banks as its subsidiaries and entered into agency agreements with effect from October 1, 1960 to establish an integrated banking and treasury set-up in the country. At the end of 1960, of 4,141 offices of scheduled banks, the number of offices of the State Bank of India and its subsidiaries accounted for 1,281 or 31% of the total. Deposits (excluding P.L. 480 funds) of the State Bank and its subsidiaries amounted to Rs. 394 crores or about one-fourth of the total deposit resources of all scheduled banks.

Advances to the co-operative sector constitute an integral part of the Scheme of State Bank's credit and other facilities. Credit limits aggregating Rs. 2·5 crores were sanctioned to 166 marketing and processing societies and those sanctioned to co-operative banks aggregated Rs. 15.18 crores. Credit limits sanctioned against warehouse receipts amounted to Rs. 2.16 crores. As many as 2,451 small industrial units were sanctioned total credit limits of Rs. 7.8 crores in 1960. The significance attached by the State Bank to a wide dispersal of its assistance was evidenced in the fact that the units enjoying limits up to Rs. 50,000 constituted 85.2% of the total number of units financed by it at the intensive centres (Source: Trend and Progress of Banking in India during the year 1960).

Subsidiary banks of the State Bank of India

The formation of the subsidiary banks of the State Bank of India is an important development in the reorganisation of the banking structure of the country. This is a sequel to the recommendation made by the All-India Rural Credit Survey Committee

for the integration of some State-associated banks with the State Bank of India. The State Bank of India (Subsidiary Banks) Act 1959 was passed to give effect to an arrangement in terms of which 8 State-associated banks, *viz.*, the Bank of Jaipur, the Bank of Mysore, the Travancore Bank, the State Bank of Hyderabad, the Bank of Patiala and the State Bank of Saurashtra are to be set up as subsidiaries of the State Bank of India by the majority interest in the capital of these institutions being passed on to that bank. The subsidiary banks continue to retain their separate entity. The authorised capital of the new banks is stipulated at Rs. 2 crores each in the case of the State Banks of Mysore, Saurashtra and Travancore and Rs. 1 crore each in the case of the other banks. The issued capital is to be of such amount as the State Bank with the approval of the Reserve Bank may fix. Compensation to the present shareholders may be paid wholly in cash or, if the shareholder so applies, partly in the shares of the reinstituted bank and the balance in cash. Under the Act, the State Bank is entitled to give directions and instructions to a subsidiary bank in regard to any of its affairs and business and the subsidiary bank is bound to comply with such directions and instructions. The Board of Directors of a subsidiary bank consists of (*a*) the Chairman of the State Bank ex-officio, (*b*) an officer of the Reserve Bank, (*c*) not more than five directors to be nominated by the State Bank of whom not more than three shall be officers of that bank, and (*d*) two directors to be elected by the shareholders other than the State Bank. The General Manager of the subsidiary bank is to be appointed by the State Bank with the approval of the Reserve Bank. These subsidiary banks are entrusted with the custody of currency chests and authorised to undertake treasury work. The changed status of these banks has enabled them to mobilise deposits through an extension of their branch now working in comparatively undeveloped areas.

CHAPTER VIII

EXCHANGE BANKS

The Exchange Banks operating in India are all incorporated outside India. They primarily finance the foreign trade in India, besides financing her inland trade. Though Indian banks are not legally prevented from participating in exchange business, yet the monopoly of the exchange business lies with the exchange banks which are specialised in this line of business for a pretty long time. Indian banks are handling this type of business no doubt, but the volume is not yet appreciable. In recent years several Indian banks have opened overseas branches. It is to be seen how they fare in the face of competition from the strongly entrenched exchange banks. Gradually Indian banks are evincing increasing interest in the transacting of foreign exchange business.

The total number of exchange banks functioning in India is 16. In recent years there has been a considerable increase in the deposits of these banks in Indian branches. These banks, by virtue of their enormous resources and experience, are serious competitors of Indian banks. They have opened a number of branches in the principal ports and trading centres of India and are financing a sizeable portion of India's inland business. Other Indian banks cannot afford to compete successfully with these largely capitalised exchange banks in view of their capacity to attract comparatively cheap deposits and to lend funds at a low rate. During the British rule in India, these exchange banks flourished under indirect patronage from the State. At that time the Indian mercantile community had legitimate grievances against their lending operations in India. It is reported that the practice of drawing import D.P. bills instead of D.A. bills is largely attributable to the want of satisfactory references from exchange banks as well as to the large profits earned by them on loan business against trust receipts obtained in connection with the delivery of goods under the D.P. system. Besides this, there is a complaint against these exchange banks that they restrict most of their credit facilities to

foreign firms with the exception of a few respectable Indian firms. Moreover, it is reported that in the matter of foreign exchange business, these banks do not co-operate with the Indian banks and in inter-bank transactions some of them politely refuse to do business with Indian banks not unoften indirectly by quoting a discriminatory rate, which discourages the Indian banks. These banks do not participate in the capital issue of Indian companies. In almost every country import bills are drawn in the currency of the country on which they are drawn and after acceptance by the drawee those may be negotiated in the discount market of the importing country. But as the exchange business is financed exclusively by these exchange banks, most of such import bills are drawn in sterling in cases of imports from Europe and the U.S.A. and as a result those bills are not available for investment to the Indian banks because of the fact that the bills drawn in foreign currency are practically of no use in the Indian money market. But for these foreign exchange banks, the change of the import bills from a sterling basis to the rupee basis would have taken place long ago in conformity with the recommendations of the Central Banking Enquiry Committee. They ask Indian exporters to insure goods with foreign Insurance Companies, and have put indirect pressure on them, which is not conducive to the interests of the Indian merchants. There are other causes for non-participation in foreign business: absence of social contacts between exchange banks and Indian business houses, indifferent to small customers, difficulty in accessibility to exchange bank managers etc. These banks often charge such high rates for currencies other than sterling that people are often compelled to purchase those currencies through the London Market instead of through India. But it should not be overlooked that lack of proper knowledge about the technicalities of foreign exchange business was also a factor responsible for non-participation in such business on the part of Indian banks. In order to curb the competitive strength of these exchange banks, Mr. Manu Subedar and Mr. N. R. Sarkar, in their evidence before the Central Banking Enquiry Committee, suggested certain terms of licence for the exchange banks. *Firstly*, these exchange banks should have to import 50% of their working capital from abroad, they should be allowed to receive so much deposits in India as are investible for the financing of foreign trade

in Indians' hands, they shall have to pay a special tax of $1\frac{1}{2}\%$ on the fixed deposits receivable in India, they shall be permitted to receive deposits from Indians if they get themselves registered in India with rupee capital and Indian Directorate, or they shall be prohibited from receiving deposits from Indians and Indian companies and firms. *Secondly*, these exchange banks should not be allowed to open branches in places other than port towns. *Thirdly*, they should not be allowed to have any controlling interest in any Indian bank. *Fourthly*, they should be prohibited from undertaking trustee business in India as this would place Indian money at their disposal. *Fifthly*, their profits in India should be subject to income tax. And *lastly*, they should be prohibited from forming any combination, ring or pool without the express consent of the licensing authority. The Central Banking Enquiry Committee held the same opinion that the financing of India's foreign trade should not be left exclusively to these exchange banks, but India should discover her own machinery for financing her foreign trade. In this connection it is suggested in some quarters that India should promote an exchange bank of her own with the co-operation of the State, Indian banks and firms so that the said Bank might be entrusted with the exclusive financing of India's entire foreign trade, instead of allowing individual banks to transact foreign exchange business by opening branches in foreign centres separately. The London Office of the Central Bank of India had to be closed, as it was not otherwise possible for that bank to withstand the formidable competition from the big exchange banks. The Central Banking Enquiry Committee recommended on the same ground that if the Imperial Bank of India were unable to participate actively in financing of India's foreign trade, Government should take steps to secure the establishment of an Indian Exchange Bank.

Many of the causes of grievances against exchange banks arising from lack of administrative control of their activities in the interests of Indian trade and commerce have disappeared with the coming into force of the Banking Companies Act, 1949. Now exchange banks are also regularly inspected by the Reserve Bank of India and they cannot carry on banking business in India unless they obtained a licence from the Reserve Bank of India on fulfilment of the conditions set out in section 22(3) of the Banking

Companies Act. Apart from the question of sound banking, the Reserve Bank is also to satisfy itself before granting a licence to an exchange bank that the Government and law of the country in which it is incorporated do not discriminate in any way against banking companies registered in India. If any of the conditions is not fulfilled, the Reserve Bank has the right to cancel the licence to carry on banking business in India and as a matter of fact, the Reserve Bank actually refused the licence to a Portuguese bank to carry on banking business in India a few years back.

In terms of the provisions of section 11 of the Banking Companies Act, 1949 an exchange bank incorporated outside India is required to have an aggregate value of paid-up capital and reserves not less than Rs. 15 lakhs and if it has a place or places of business in the City of Bombay or Calcutta or both Rs. 20 lakhs. Moreover, it is also required to keep deposited with the Reserve Bank an amount not less than the minimum prescribed as above either in cash or unencumbered Government securities or partly in cash and partly in Government securities. This amount shall, in the event of the company ceasing for any reason to carry on banking business, be an asset on which the claims of all the creditors of the banks in India shall be a first charge. Again in order to prevent the flight of capital abroad it has been provided in section 25 of the Banking Companies Act that the assets of every banking company including the exchange banks shall not be less than 75 per cent of its demand and time liabilities at the close of the last working day of every quarter. Besides these, exchange banks are required to prepare their balance sheets and profit and loss accounts in respect of their business in India in terms of section 29 of the Banking Companies Act. The extent of their total business in India can be gauged from the statistics given below:

(In lakhs of rupees)

Year	Deposits	Investments in Govt. securities	Loans and advances	Bills discounted and purchased	Net profit
1949	165,88	49,15	105,61	16,49	2,24
1950	174,16	48,33	112,73	23,01	2,09
1951	169,84	45,16	148,69	25,83	3,14
1952	176,50	43,34	131,00	19,31	1,87
1953	165,84	45,97	110,71	20,44	1,39
1954	178,49	46,39	124,94	25,75	1,25

(In lakhs of rupees)

Year	Deposits	Investments in Govt. securities	Loans and advances	Bills discounted and purchased	Net profit
1955	195,13	46,01	141,79	31,88	1,68
1956	187,54	39,27	161,22	40,64	1,66
1957	204,14	38,91	143,87	50,42	1,92
1958	195,76	44,74	134,73	25,36	1,03
1959	226,21	42,93	140,99	30,10	1,29
1960	238,95	39,82	176,33	34,84	2,15

Indian Joint-Stock Banks

The Allahabad Bank Ltd., the Bank of India Ltd., the Bank of Baroda Ltd., the Central Bank of India Ltd., and the Punjab National Bank Ltd., are popularly called the "Big Five" of India.

The Bank of India was registered in Bombay in the year 1906 during the time of the Swadeshi movement with a capital of Rs. 50 lacs. Since its registration the Bank is fortunate in commanding unimpeachable credit and untarnished reputation in the sphere of banking in India. It followed the traditional policy of commercial banking on the model of English banking and adopted all through a conservative and extremely cautious policy. Till 1927 it had no branch office, even though its capital, reserves and deposits exceeded at the time Rs. 5 crores. In 1938 it had only 16 branches. Of all Indian Banks, it had its first office in London, primarily intended for financing India's foreign trade. From this it appears that the Bank has since discarded the ultra-conservative policy and embarked upon activities of expansion. At the outset the Bank used not to make any advance against shares or mortgage. Later on in 1911 it reoriented its policy and now makes such advances on a restricted scale. The Bank possesses three special features, *viz.*, fewness of its branches, concentration in urban and industrial centres, and highly liquid position. Naturally it is not surprising that it can work on a low expense ratio as compared with other leading joint-stock banks. In recent years this bank has considerably increased the number of its branches and has also opened offices abroad. Its deposits as at the end of 1960 stand at Rs. 106·63 crores and the number of branches is 53.

CENTRAL BANK OF INDIA

The Central Bank of India was started in 1911 under the able guidance of Late Sir Sorabji Pochkanwalla. The history of this largest joint-stock bank of India has passed into the legend of romance in banking. The bank had an eventful career and had to steer clear of multitudes of difficulties interposed by so-called "credit-wreckers". Through the dash and genius of Sir Sorabji the bank had emerged in flying colours out of many ordeals. The amalgamation of the Tata Industrial Bank with the Central Bank in 1923 was virtually the corner-stone of the latter's unique position. With that amalgamation the capital and reserves of the bank rose from Rs. 80 lacs in December, 1922 to Rs. 268 lacs in December, 1923. The deposits also marked, as a result, a rise from Rs. 14 crores to Rs. 18 crores. Unlike the Bank of India it vigorously pursued branch expansion policy and its number of branches stands over 300. It was the first Indian bank to open its office in London, which had unfortunately to be closed in 1934. It has since been reopened. The Central Bank now claims to be the largest joint-stock bank in India with deposits at Rs. 195·62 crores as at the end of 1960.

PUNJAB NATIONAL BANK LTD.

It was started in 1896 with a capital of Rs. 41,000/- only and deposits of about Rs. 1½ lacs. Gradually its deposits exceeded Rs. 1 crore, after the first flush of the Swadeshi movement in 1910 and its paid-up capital and reserves were well over Rs. 15 lacs. The Bank successfully withstood the bank crisis during 1913-14, although its deposits declined from Rs. 147 lacs in 1912 to Rs. 77 lacs in 1914. The bank then set itself to the task of retrieving its old position and by 1916 its deposits again exceeded the mark of Rs. 1 crore. After the depression of 1930 the average deposits were maintained at the level of Rs. 7 crores. In January, 1940 the Bank absorbed a scheduled bank named Bhagawandas Bank Ltd. In the year 1938 the bank had 38 branches. After the Bharat Bank Ltd. has been partially merged with it, the number of its branches has further increased. It has deposits at Rs. 138·14 crores and the number of branches at 394 as at the end of 1960.

ALLAHABAD BANK LTD.

The Allahabad Bank is one of the oldest joint-stock banks in India. It was registered in Allahabad in 1865 with a capital of Rs. 1·9 lacs. By 1900 its paid-up capital rose to Rs. 10 lacs and its deposits exceeded Rs. 2 crores. All along it adopted a cautious policy of expansion. By 1938 its number of branches was 56, largely concentrated in U.P. and the Punjab. In 1922 the Bank was affiliated to the P & O Banking Corporation and later on that affiliation was transferred to the Chartered Bank of India, Australia & China, which in 1927 held the major bulk of the shares of the P & O Banking Corporation and finally absorbed the latter in 1938-39. The bank, since its inception, was never free from the influence of the Europeans. As at the end of 1960, its total deposits amount to Rs. 50·80 crores and the number of branches is 88.

BANK OF BARODA LIMITED

The Bank of Baroda was established in 1909 under the patronage of the Baroda State. During World War I its deposits exceeded Rs. 1 crore and in 1920 reached the peak of over Rs. 5 crores. In 1938 its number of branches was 23, mostly concentrated in Gujrat and Kathiawar. By 1960 the bank has opened a number of branches in different parts of the country as well as abroad. The total number of such branches is 88 and its deposits aggregate Rs. 84.96 crores as at the end of 1960.

WAR TIME TREND IN INDIAN BANKING

It will be worth-while to take stock of the banking progress during the war time. The direct effect of the last war (1939) was a considerable expansion of bank deposits which will be evident from the figures given below:

INDIAN SCHEDULED BANKS

(In lacs of rupees)

	1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46	1946-47
Demand Liabilities	139·65	163·90	211·35	306·26	456·63	584·80	654·53	725·54
Time Liabilities	106·03	104·94	107·61	104·21	142·78	194·12	259·52	323·11

It will appear that the increase was reflected mostly in the demand liabilities in comparison with time liabilities. This shows liquidity-preference on the part of the depositors. This is a striking contrast with the tend in deposits of Indian banks during 1920-29, when the time liabilities exhibited a relative increase in comparison with the demand liabilities. This remarkable shift from time deposits to demand deposits arises from a variety of factors, *viz.*, overall preference for liquidity, low interest on time deposits, war-time controls and rationing, bringing about a significant decline in the velocity of circulation of money leading to the accumulation of idle funds in the hands of the consumers and business men, etc. But a marked departure was noticed from the above trend during 1947, when time deposits rose relatively to demand deposits as will be perceptible from the statistics given below:

TREND OF BANKING IN 1947

(In crores of rupees)

	28-12-45	6-12-46	5-12-47	Changes in 1946	Changes in 1947
Demand Deposits ...	672·57	738·08	734·62	+65·51	−3·46
Time Deposits ...	280·26	330·91	342·63	+50 65	+11·72
Total Deposits ...	952·83	1,068·99	1,077·25	+116·16	+8·26
Cash in Hand ...	42 39	42·33	40 45	−0·06	−1·88
Balance with Reserve Bank	78·44	81·29	113·17	+2·85	+31·88
Total Cash	120·83	123·62	153·62	+2·79	+30 00
(*a*) Advances ...	302·89	423 86	403·88	+120·99	−19 98
(*b*) Bills	24·30	22·79	17·83	−1·51	−4·96
Total of (*a*) & (*b*) ...	327·19	446·65	421·71	+119·66	−24·94
Estimated Investments ...	504·81	498·72	501·92	−6·09	+2·80
	%	%	%		
Ratio to Deposits of Cash	12·7	11·6	14·3		
Advances and Bills ...	34·3	41·9	39·2		
Investments	53 0	46·6	46·6		

N.B. *Highest Levels Touched during the year 1947 were:*

Demand deposits: Rs. 738·81 crores in 17/1 (Rs. 767·90 crores on 22-11-46).

Time deposits: Rs. 350·36 crores on 16/5 (Rs. 330·95 crores on 27-12-46).

Cash in hand: Rs. 48·55 crores on 3/1 (Rs. 43·04 crores on 15-11-56).
Balance with the Reserve Bank: Rs. 121·16 crores on 29/8 (Rs. 109·35 crores on 5-7-46).
Advances and bills: Rs. 492·17 crores on 28/3 (Rs. 446·65 crores on 6-12-46). Figures within brackets relate to the corresponding position in the previous year.

From the above table it will appear that total deposits marked a negligible rise of Rs. 9 crores only. It was expected that due to the reduction of Government expenditures on the cessation of hostilities, deposits would tend to decline and actually there was the decline. But this decline indicates that fresh savings have not been formed on account of a variety of causes, like fall in production accompanied by a declining profit, increase of taxation, spiral of rising prices and high cost of living, and the transfer of capital to the United Kingdom. The increase in time deposits and the comparative decline in demand deposits will, on the face of it, suggest that liquidity-preference has waned but the real fact is that a large section of investors disposed of their holdings in equities and gilt-edged securities for lack of confidence and kept their funds in fixed deposit with the bank, usually for a short period. During the first five months of the year 1947, demand deposits suffered a progressively sharp fall from Rs. 738·81 crores to Rs. 664·50 crores —a drop of Rs. 74·31 crores. This is explained by the fact that much fund got an outlet for purchases of imports, which were so long restricted, but permitted at that time. Besides this, large transfers of funds to foreign markets took place owing to a speculation about the probable depreciation in the value of the rupee and the possibility of a ban on capital transfers. But in the 2nd half of the year (1947), the fall in demand deposits was recouped, as those deposits shot up to Rs. 734·62 crores on the 5th December, 1947, showing a rise of Rs. 70 crores. Such a recovery is explained by the imposition of restrictions on imports once again, releasing of money which got blocked up in stocks due to restricted movements It is held in some quarters that the total deposits would have suffered a set-back in the year 1947 but for the liquidation of the investment by the general public and institutional investors.

ADVANCES AND BILLS

An analysis of the scheduled banks' advances and discounts will show their irregular and erratic behaviour, influenced as those were by seasonal factors and war developments.

	Percentage to Total & Discounts (in lacs of rupees)	Total Advances Liabilities
1938-39	120 71	50·75
1939-40	131·14	53·38
1940-41	125·97	46 86
1941-42	125·13	39 23
1942-43	97 86	23 83
1943-44	161 73	26 98
1944-45	235 38	30 22
1945-46	301·12	32 94
1946-47	427·71	42 79

A declining tendency in discounts and advances is perceptible from the above figures but there was a steady recovery after 1943. The upward trend in advances and discounts was maintained till the first quarter of 1947, when there was a great demand for funds for meeting interest requirements, supported by a high level of activity in imports. Moreover, funds were needed for paying taxes, dividends, and bonuses to staff. Thus advances rose to Rs. 492·17 crores by the end of March, 1947, whereafter they began to decline until they touched the year's lowest level of Rs. 413·02 crores in the second week of October, 1947. Again they rose to Rs. 425·61 crores by the 5th December, 1947. Anyway, the advances and discounts showed a fall of Rs. 25 crores compared with those of the previous year. Still the higher volume of advances may be attributable to the high price level prevailing during the year and the demand for a larger volume of finance for a limited quantity of goods. The decline in advances towards the latter part of 1947 is attributable, to a great extent, to the curtailment of fresh commitments, withdrawal of old credit as a precautionary measure in view of the grave political uncertainties of the country.

Cash: As contrasted with the steady maintenance of cash ratio by London Clearing and Canadian Banks, Indian scheduled banks had to work on a higher cash basis, which widened from 9·98% in 1939-40 to 14·96% in 1944-45.

1939-40	1940-41	1941-42	1942-43	1943-44	1944-45	1945-46	1946-47
9 98%	16 66%	14 58%	16 73%	14 05%	14·96%	13 64%	11·67%

The maintenance of a high cash ratio was necessitated because of a sense of uncertainty and nervousness prevailing in the country on account of the menacing communal disturbances. In August, 1947, the cash ratio of banks was as high as 14·40%, which reached the highest peak of 15·61% on the 29th August, 1947. But as the political tension ceased to some extent, strictness in the observance of caution was partly relaxed and the cash position came to 14·3% towards the end of 1947, as contrasted with 11% a year ago.

Investments: An idea can be formed of the behaviour of bank investments in India from the table given below:

(In lacs of Rupees)

	1938	1941	1942	1943	1944	1945
Imperial Banks ...	43·72	64·39	116 42	130 20	148 63	154·18
Other scheduled banks ...	39·63	58·52	101·77	157·02	231·41	278 52
Non-scheduled banks (with capital and reserves of Rs. 1 lac & over) ...	3·41	5·80	8·32	10·04	16·56	27 66
	86·76	128·71	226·51	327·26	396·60	460·36

Although the total investments increased, the ratio of investments to deposits fell from 59·3% in 1942 to 53% in 1943 and the tendency of decline persisted till 1947.

RATIO OF INVESTMENTS TO TOTAL DEPOSITS OF THE ABOVE THREE TYPES OF BANKS

1938	1941	1942	1943	1944	1945	1946 (6th Dec.)	1947 (5th Dec.)
46·1%	49 9%	59·3%	53·0%	53 6%	51·6%	46·6%	46·6%

On the whole, the Indian banks stood up to the shocks of war and the post-war repercussions admirably well. The crash in the stock exchange precipitated the elimination of some weaker banks. Many non-scheduled banks had to succumb to the stock exchange crash and the political uncertainties of the country. There was a heavy mortality of these non-scheduled banks in Bengal

during the year 1947. As pointed out by the Governor of the Reserve Bank of India, most of the trouble of these non-scheduled banks was largely due to "mismanagement, indiscriminate opening of too many small branches, reckless lending operations, speculative operations on the stock exchange and lack of properly trained personnel"[2]. The Reserve Bank of India showed an accommodating spirit this time by an open declaration of its readiness to purchase from the banks in trouble their Government securities. Moreover, the Reserve Bank helped in averting a banking crisis in November, 1946, in Calcutta by a timely clarification of some misconceptions that lingered in the minds of the public. Moreover, the assumption of certain powers by the Reserve Bank of India under Banking Companies (Inspection) Ordinance, 1946, and the Banking Companies (Restriction of Branches) Act, 1946, produced salutary effects on the development of banking on sound and safe lines. The latter Act succeeded in checking indiscriminate opening of branches, as will be clear from the table given below:

BRANCHES OF SCHEDULED BANKS (INCLUDING H. O., PAY-OFFICES AND SUB-OFFICES)

	30-9-47	30-6-47	31-3-47	31-12-46	30-9-56
Imperial Bank ...	444	447	446	445	438
Big Five in India ...	779	779	783	779	712
Exchange Banks ...	80	80	88	87	87
Other Scheduled Banks	2,223	2,253	2,259	2,239	2,071
	3,526	3,559	3,576	3,550	3,308

Up to June, 1947, applications were made to the Reserve Bank of India for opening 143 new branches and for shifting the location of 84 existing branches. But the Reserve Bank of India gave licence for opening only 84 new branches and for shifting the location of 79 existing branches. The power of inspection of any bank by the Reserve Bank of India will, it is believed, eradicate some of the undesirable tendencies that have grown up in banking in India. It has been pointed out by Sir C. D. Deshmukh that some banks have developed a tendency of acquiring non-banking companies by purchasing their shares at an inflated price regardless of their possible adverse repercussions on their financial position. Allied to this is the growing propensity of interlocking of interests and directorate between banks and other business undertakings.

Such a tendency should be deprecated by all means, as it serves the private ends of the management, contrary to the interests of the institution. Moreover, many banks are prone to open branches indiscriminately without careful preliminary prospecting in each case in the light of existing banking facilities, the size of available business and the likely changes therein and reasonable earnings. This leads to a quest for deposits at a disproportionately high rate, which strikes at the root of safe banking. Branch-banking is possible provided there is an adequate supply of trained personnel. But in the present circumstances, trained personnel has become limited in supply. Naturally, branch banking with untrained personnel must be fraught with heavy risks.

Another disquieting feature which was pointed out by the Reserve Bank of India in the sphere of banking was that the investments of Indian scheduled banks, excluding the Imperial Bank of India, the Exchange Banks and some of the bigger scheduled banks, were not properly balanced and they included a very high percentage of securities maturing after 10 years. The percentage of securities maturing within 10 years was only 12 per cent, while the percentages of securities maturing within ten to fifteen years and after fifteen years were 31 and 57 respectively at the end of 1946. It has been stated that the demand liabilities of Indian banks being higher than time liabilities, banks holding such long-term securities may have to face difficulty in disposing of these securities to meet withdrawal of deposits. So it has been suggested by the Reserve Bank of India that banks which already had followed a wrong policy during the past should gradually reduce their long-term securities so that they do not disturb the Government securities market and are able to spread losses, if any, over a period of time. "A balanced maturity distribution of Government securities is a feature of the banking practice of well-managed banks all over the world and banks in India will do well to adopt such a policy as and when circumstances permit, in their own interests, if not for the safety of the banking system and the health of the money market." (C. D. Deshmukh)

Many banks are found adopting the practice of excessive "window-dressing" which should be discarded for the sake of sound banking. Even the English banks, which so long took to window-dressing, have since decided to abandon this malpractice. If our

Indian banks discard these malpractices, proceed on lines of caution without being influenced by the "get-rich-quick-policy", build up an adequate number of trained personnel, consolidate the gains already achieved during the war instead of further expansion, which will become unwieldy in management, avoid speculative dealings in stock-exchange securities and confine themselves to pursuit of sound and safe policies, they will be able to steer clear of the uncertainties of the post-war period and establish themselves firmly in the near future. The Reserve Bank of India has already declared that it will be always agreeable to come to the aid of banks which become involved in difficulties which are not of their own making. It is believed that such a helpful attitude on the part of the Reserve Bank will pave the way for the establishment of Indian banking on a stable basis.

Post-war Trend in Indian Banking

The following table brings out the main trends in scheduled bank credit and relative items during the year 1948-51:—

(In crores of rupees)

End of	Advances and bills discounted.	(1) as percentage of (7).	Cash and balance with the Reserve Bank	(3) as percentage of (7).	Deposits Liabilities. Demand	Time	Total
	1	2	3	4	5	6	7
1948-49 ...	496·46	54·2	89·73	9·8	630·58	285·27	915·86
1949-50 ...	462·32	54·1	83·04	9·7	593·38	261·42	854·80
1950-51 ...	546·87	60·3	93·29	10·3	616·26	289·95	906·21

Deposits.—Half-yearly surveys of ownership of deposits of scheduled banks disclosed that total deposits increased from Rs. 840 crores as at the end of June 1950 to Rs. 850 crores at the end of December 1950 as against Rs. 826 crores at the end of 1949. The relative importance of demand, savings and time deposits remained almost unaffected during the year, their respective proportion to total deposits standing at 57, 16 and 27 per cent at the

close of the year. The pattern of ownership of the various types of deposits also showed a little change. Personal deposits continued to predominate in respect of savings as well as time deposits, accounting for 96 per cent of the former and 57 per cent of the latter as on the 31st December 1950. The bulk of demand deposits continued to be business deposits ; as a percentage of total demand deposits they rose from 50·9 at the end of June 1950 to 52·4 at the end of December 1950 ; personal deposits declined from 29 per cent to 27·5 per cent of total demand deposits.

Investments.—Half-yearly surveys of investments showed that total investments of scheduled banks rose from Rs. 403 crores at the end of December 1949 to Rs. 416 crores at the end of December 1950, the rise being confined to the latter half of the year. Investments in Government securities remained around 88 per cent of the total at the end of both the half-years. The proportion of long-dateds (maturing after 15 years) and medium-dateds (maturing between 5 and 15 years) in the portfolio of Government securities declined from 17 per cent and 56 per cent respectively at the end of June 1950 to 15 per cent and 52 per cent respectively at the end of December 1950 and that of short-dateds rose from 26 per cent to 33 per cent. The proportion of total investments in shares and debentures, other trustee securities, foreign investments and 'others' remained almost unchanged at about 3, 2, 5 and 2 per cent respectively at the end of both the half-yearly periods.

Advances.—Quarterly surveys of advances of scheduled banks, by purpose and by the nature of the security offered, showed that movements in advances mainly reflected seasonal trends in the demand for bank credit. The Table below gives the distribution of scheduled bank advances according to purpose.

End of	Amount (Rs. crores)	Industry % of (1).	Commerce % of (1).	Agriculture % of (1).	Personal and Professional % to (1).	Others % of (1).
December, 1949	438 5	30·4	51·4	1·9	8·7	7 6
March, 1950	498·4	31·5	52·1	2·3	7·9	6 3
June, 1950	475·7	32 5	50 1	3·2	8·2	6 0
September, 1950	438 3	34·0	47 6	3·3	9·4	5·6
December, 1950	475 6	32 0	51·7	2·3	8·9	5·1

Advances to the cotton textile industry represented 8·3% of the total advances at the end of 1950 as against 6·6% at the end of 1949, and advances to the sugar industry ranged between 2 per cent and 5 per cent during the year. Advances to wholesale traders in agricultural commodities showed a pronounced seasonal variation ranging between 15% of the total advances at the end of June and 11% at the end of September; similarly, advances to banks and other financial institutions rose from 8·3% of the total advances at the end of December, 1949 to 7·2% at the end of March and declined to 7·0% at the end of June, at which level they remained for the rest of the year.

Advances against Government and trustee securities declined from 11.5% of the total advances at the end of 1949 to 9·5% at the end of 1950; advances against shares and real estate showed a decline from 12·0% and 5·2% respectively, to 11·2% and 4·7%. On the other hand, advances against merchandise, which continued to form the bulk of scheduled bank credit, increased from 40·5% to 44·7% during the year, and advances against bullion rose from 2·2 to 3·1 per cent. The proportion of secured advances stood lower at 85·7% at the end of 1950 as against 86·6% at the end of 1949.

Non-Scheduled Banks.—The total deposits of non-scheduled banks fell from Rs. 40 crores at the end of December, 1949 to Rs. 35 crores at the end of February, 1950 and rose to Rs. 39 crores by the end of June; they remained at about Rs. 38 crores till November and closed for the year at Rs. 37 crores. Cash balances of non-scheduled banks stood at Rs. 3·6 crores at the end of December, 1950. The cash ratio generally remained at around 8·9%. Loans and advances stood at Rs. 28·4 crores in December, 1950 as against Rs. 30·4 crores in December, 1949. Their ratio of total deposits remained unchanged at 76% as at the close of both years. It would appear that the proportion of time deposits, which continued to account for the bulk of total deposits, tended to rise progressively standing at 59·1% at the end of December, 1950 as against 52·9% at the end of 1949; correspondingly demand and savings deposits showed a downward trend. The bulk of demand deposits, amounting to more than 50% of the total, continued to be held in business in 1950, though their proportion to the total

tended to be downward; in contrast, personal deposits which accounted for more than a quarter, tended to rise. Personal ownership of savings and time deposits rose to about 88% and 70% of their respective totals. Ownership of savings and time deposits by business averaged 7% and 22% respectively and the proportion tended to be downward.

Half-yearly sample surveys of investments of non-scheduled banks showed that Government securities constituted about 79% of the total, which represents a slight rise during the year. As at the end of the year short-dated securities represented 16% of total holdings of Government securities, medium-dateds 45% and long dateds 38%. Shares and debentures averaged about 10% of total investments, "other trustee securities" somewhat more than 2%, fixed deposits 2% and others about 5%. The total advances of non-scheduled banks stood at Rs. 41·0 crores at the end of December, 1950 as against Rs. 43·5 crores at the end of December, 1949. While industrial and personal and professional advances showed a downward trend, commercial, agricultural and other advances recorded an increase. Advances against Government and trustee securities accounted for less than 1% of the total advances as against about 10% in the case of scheduled banks. Advances against shares and merchandise declined and advances against real estate and bullion increased. Secured advances of non-scheduled banks declined from 79·1% at the end of December, 1949 to 77·9% at the end of 1950, the corresponding percentages for scheduled banks being 86·6 and 85·7 respectively.

General observations.—Due to the impetus given by the war and post-war inflationary conditions, the resources of the banking companies have undergone a tremendous expansion, their investments, advances and also branches showing a phenomenal rise. The first set-back occurred with the partition of the country in 1947. The disturbances preceding and following partition dislocated the working of some banking companies operating in the affected areas of the Punjab and Bengal and crippled many others. A considerable portion of their assets had perforce to be left in Pakistan with the result that their creditors who had migrated to India were put to inconvenience. A number of banking companies had to suspend payment and later to adopt schemes of arrangement. The realisation of the assets presented a number of problems as no satisfactory

arrangement for the mutual transfer of assets and liabilities between the two countries could be arrived at and the results of the Inter-Dominion agreement on Banking are not noteworthy. The war-time expansionist phase of Indian banking is now on the wane. To play their rightful part in the development of the country's economy, it is necessary that Indian banks should devote greater attention to the consolidation of their resources and to the building up of sound banking traditions.

The year 1955 was significant not only for the increased volume of banking business but also for the momentous and far-reaching organisational changes that occurred in the banking sector. Steps were taken to ensure wider banking facilities and to strengthen the banking structure so as to equip it better for its important role in coming years in the finance of diverse forms of economic activity.

Over 1955, scheduled bank credit expanded by Rs. 80 crores, as against an increase of Rs. 57 crores in 1954 and a fall of Rs. 10 crores in 1953. The expansion of bank credit in the busy season of 1954-55 at Rs. 107 crores was lower by Rs. 5 crores than in the busy season of 1953-54. What was of greater interest, however, was that in the ensuing slack season, the return of funds to the banking system was no more than Rs. 32 crores which meant that well over two-thirds of the total credit made available earlier, remained in the pipe line.

The resources position of the Indian banking system was fairly comfortable. In 1955, in continuation of the trend in the two preceding years, the deposits of scheduled banks increased by Rs. 91 crores to Rs. 1,013 crores, passing the Rs. 1,000 crore level for the first time in seven years. An interesting feature as regards the Reserve Bank's lending has been that while hitherto the Indian banks had been the main borrowers under the Bill Market Scheme, in 1955, exchange banks also exhibited considerable interest in the Scheme.

Over the year, the relatively larger increase in bank deposits than in bank credit and the reduction of cash reserves helped scheduled banks to add to their investment portfolios by as much as Rs. 42 crores. The profit and loss accounts of 18 larger Indian scheduled banks showed that during 1955 their gross earnings registered a rise of Rs. 3·8 crores to Rs. 85·0 crores, over three-fifths

(Rs. 2·4 crores) of this being accounted for by the rise in interest and discount earned. Total expenses also rose significantly—by Rs. 3·4 crores, more than one-third of which was made up of an increase in interest paid on deposits, borrowings etc. Net profits, therefore, went up by Rs. 0·4 crore to Rs. 5·7 crores.

Since then the deposits of the scheduled banks in India have considerably increased. Their deposits have risen to Rs. 1,953 crores and the number of their offices has gone up to 4,149. In addition, they have opened as many as 97 branches in foreign countries. The investments of these scheduled banks in Government securities aggregate Rs. 628 crores and their loans and advances (including bills discounted and purchased) stand at Rs. 1,217 crores as at the end of 1960. "Cash reserves of scheduled banks had reached the height of Rs. 172 crores on July 15, 1960 with the cash ratio rising to 8·8%. At the end of June 1961, the reserves stood at Rs. 145 crores and the cash ratio at 7·5% as compared to 7·9% a year before. The excessive strain on resources resulted in a larger resort by banks to the Reserve Bank, despite the introduction of the system of slab rates on October 1, 1960". (Report of the Reserve Bank's Central Board of Directors for the year ended June 30, 1961).

The total number of banks which have been granted licences is 65 at the end of June 1961. The deposits of these banks together with the deposits of the State Bank of India and its subsidiaries which do not require a licence, constitute about 96% of the total deposits of all scheduled and non-scheduled banks operating in India.

An analysis of the Profit and Loss Accounts of 26 large Indian scheduled banks for the year 1960 showed an appreciable rise in their net profits over the preceding year. During the year the net profit went up to Rs. 9·2 crores showing a rise of Rs. 1·8 crores or nearly 25% over 1959. Gross earnings (largely made up of interest and discount) increased by Rs. 7 crores to Rs. 75·8 crores; the rise was Rs. 7·3 crores in 1959. Obviously gross earnings should have risen higher in 1960 than in 1959 consequent on a rise in both the level of credit and in the binding rates of banks (Source: Trend and Progress of Banking in India during the year 1960).

Reserve Bank's Suggestions for Strengthening the Banking System

(i) Some of the directors of banking companies lack the knowledge and experience necessary for the exercise of adequate supervision over the activities of the chief executive officers, which enables these officers to exercise wide powers while making investments and advances. In a few cases, the system of internal audit and inspection was found to be defective. Some banking companies were in the habit of declaring dividends without making adequate provision for bad and doubtful debts, depreciation in investments and other unrealisable assets etc.

(ii) *Investment policy.*—In the case of some banking companies investments in Government securities were low in proportion to their resources while in a few cases frequent borrowing reduced the liquidity ratio. Some banks held shares of companies in which some of the directors were interested and also shares which were not readily marketable.

(iii) *Lending policy.*—The advances of some of the banks were entirely out of proportion to their resources and in a few cases clean advances preponderated, while the machinery for investigating the creditworthiness of the borrowers was defective. Some banks ignored the principle of diversification of risks.

(iv) *Branch Banking.*—It was observed in the case of some of the banking companies that the system of supervision over branches was unsatisfactory, and regular returns of advances etc. were either not called for or not properly scrutinised at the head office.

(v) Among the legislative provisions enacted for the improvement of banking conditions in India, the following may be mentioned:

(a) The banking crisis in Bengal, following the Stock Exchange debacle in Calcutta, revealed that the provisions of the Reserve Bank of India Act, 1934 in regard to the grant of financial assistance to scheduled and non-scheduled banks in difficulties were not adequate to meet the situation. The Reserve Bank of India Act was, therefore, amended by means of an Ordinance. Even after the emergency was over, the powers granted by the Ordinance were continued by an amendment of Section 18 of the

Reserve Bank of India Act. This step has enabled the Reserve Bank to assist a number of banking companies in 1948, 1949 and 1960.

(b) The administration of the Banking Companies Act revealed that the provisions relating to liquidation and amalgamation of banking companies were not adequate and the Banking Companies (Amendment) Ordinance, 1949 was promulgated for the speedy disposal of winding up proceedings. Provisions relating to the procedure for facilitating quick amalgamation between banking companies were also incorporated in the Banking Companies (Amendment) Act, 1950. Subsequently, the Act has been further amended to simplify the liquidation proceedings, expedite payments, to small depositors and to bring about compulsory amalgamation in suitable cases.

(vi) In the context of the Third Five-Year Plan, Indian banks have to shoulder greater responsibilities in the matter of providing increased finance to various enterprises and there will be a larger demand on their resources. The investment under the Third Plan is about 50% higher than of the Second Plan. Banks will, therefore, have to intensify their efforts to mobilise deposits and for this purpose, they may have to accelerate the expansion of their branches. There are about 1,400 townships where no banking facilities are available at present. There is thus scope for extension of the branch network in those areas. "The relatively higher rate of deposit growth of bank branches in centres with a population of less than 50,000 during the Second Plan period seems to suggest that there is a good deal of banking potential to be tapped in these centres, and the scope for expansion continues to widen with the growth of economic activity." Along with this, banks should build up sizeable capital funds, particularly through increase of their reserve funds and inner reserves from their current profits, besides issuing fresh capital whenever possible. In recent years, there has been a decline in the cash and liquidity ratios of banks. They should not allow further fall in the above ratios and make every possible endeavour to step up those ratios. To strengthen the banking system, The Reserve Bank intervenes to bring about compulsory amalgamations of the weaker banks and the Deposit Insurance Corporation has also been set up on the 1st January 1962 to afford protection to the depositors up to certain

limits. These measures are sure to restore public confidence in the banking system and stimulate a larger rate of deposit growth.

The inevitable growth in the scale of operations necessitates further specialisation of banking functions, their proper co-ordination as well as diversification in the avenues and techniques of lending. This will invariably involve proper training of the bank staff to meet the challenge of a developing economy. Banks should, therefore, pay greater attention to the intensive training of their staff by making suitable arrangements so that their plans for expansion may go hand in hand with staff efficiency. It is gratifying to note that several banks have already made a move in this direction.

"In tune with the rising requirements of a developing economy, banks would be called upon to extend a variety of services to enter to the varying needs of business and individuals. Banks have already ventured into the sphere of underwriting of new issues. They have also been instrumental in the conclusion of deferred payments agreements between the units in Indian industry and foreign collaborating firms. There are other directions in which banks can take the initiative. The small man in the country does not enjoy adequate facilities for remittance and payments at reasonable cost. Banks may, therefore, consider the scope for a credit transfer scheme, even on a limited basis, on the lines of that introduced in the United Kingdom recently" (Source: Trend and Progress of Banking in India during the year 1960). The suggestion made in respect of cheap transfer facilities has been readily accepted by some lending banks in India.

Cheap Money Policy and Banking

Much controversy has, of late, brewn over the application of the cheap money policy and its continuance at the present stage. Usually, cheap money policy is pursued in time of depression to stimulate business activities, so that the business men may extend their business operations by borrowings at a cheap rate. In such a situation the Government intervene and bring about a reduction in the borrowing rate by open market operations, supported by a certain amount of inflation. With the outbreak of war on September 3, 1939, the Government of India pressed into service

the cheap money policy to raise funds from the market to meet the ever-mounting war expenditures, supported by the control of capital issues and the enforcement of other forms of economic controls. Now as the war has ended, there has been a plea for not continuing the cheap money policy further, as its continuance, made so long possible under highly controlled conditions of war, will be fraught with risks in the present transition of the country from war-time footing to peace-time economy. It is, no doubt, true that the Government of India will require huge funds at a low cost to execute the developmental and reconstruction projects in the post-war period, but the objective was sought to be achieved by Sir Archibald Rowlands, not in a slow degree by injecting low money rates into the economy, but at a rapid pace by a deliberate policy of cheaper money. This he tried to do by floating in the market new loans at a low rate in quick succession and by conversion of 3½% undated loans into 2¾% thirty-year loan or a 3% forty-year loan with option to extend the date of repayment indefinitely. But the market conditions were not favourable for such a policy at that time. In the wake of the announcement of the 2¾% loan repayable in 1960, came the Demonetisation Ordinance of January, 1946, which badly shook the financial market. Naturally, the loan failed to evoke ready response from the market. The 2½% 1961 loan issued in July, 1946, was a marked success, but the announcement of a second issue of the same loan without providing for sufficient time was a severe strain on the absorbing capacity of the market. In short, these new loans were floated in the market at such a time when the market was not equally responsive, as the country was then suffering from the throes of political uncertainties and communal disturbances.

As compared with the position in 1945, the investments of the banks in relation to deposits marked a decline from 53% to 46% in 1946. This shows that the banks' dependency on Government as the principal source of outlet for their funds was reduced, as there was trade demand for bank funds in other directions. The cheap money policy encroaches upon the income of the banking system no doubt, but in India the reduced income derived from the low advance rate was compensated, in most cases, by the appreciation of the value of Government securities in banks' port-

folios. Besides investments, the banks are to earn income by advances and discounts. But this source remained unaffected by the Government's bid for cheap money. In spite of the Government borrowing at a cheap rate, the business men had to pay high rates of interest for advances, as there was a marked rise in demand for bank advances. In 1945, banks' advances and bills stood at Rs. 327 crores, while in 1946 those items rose up to Rs. 447 crores. This unmistakably points to the fact that the cheaper money has failed to percolate through banks to the business men. In spite of the reduction in the currency expansion, the bank deposits steadily rose. The net increase in the volume of money in circulation during 1946 was more than Rs. 31.63 crores, while deposits increased by Rs. 116.16 crores during the same period.

The Reserve Bank of India issued the following circular to all banks with a view to lending support to the cheap money policy:

> "As a result of the continuance of the cheap money policy followed by Government, it is expected that the rate of interest earned by scheduled banks on their investments will be lower than hitherto, though their total profits may not appreciably decline, since, as a result of the greater trade activity there may be a great demand for bank finance. It is also not likely that there will be any reduction in the near future in the cost of management of banks. In view of this, it has been suggested to us that the present is the time when scheduled banks may revise their rules of business so as to discontinue the payment of interest on current deposits and lower the rates of interest paid by them on savings and time deposits. The rates allowed by scheduled banks vary from place to place, and from bank to bank ; they also vary according to the period of the deposit. But the banks concerned are able to attract substantial deposits which would indicate that the rates of interest paid by them do not directly affect the volume of their deposits. As in the case of the return on investments, it may be taken as a general proposition that the rate of interest paid by a bank on its deposits is in inverse proportion to its soundness. In progressive banking systems like the English or American, no interest is paid on current deposits and in fact a charge is imposed on constituents for keeping

current accounts ; the rates paid by banks must depend on the development of banking habit but in the interest of the agricultural, commercial and industrial development in the country, it is desirable that the rates of interest charged by banks be gradually reduced and if banking is to develop on sound lines even with a lowering of the rates for advances, it automatically follows that there should be a similar lowering in the rates of interest on deposits. The economic development being uneven in the various parts of the country, for instance, in the mofussil centres, it may not be possible to attract deposits if a uniform rate is adopted for the whole of India. There should, however, be no objection to uniform maximum rates for each centre to cut down uneconomic competition between banks."

Contrary to the intention of the Reserve Bank of India a large section of depositors still insists upon some return on the deposits and very few of them will agree to a general reduction in the rate of interest. Many depositors consider interest on their deposits as a supplementary source of their income, and as such can hardly afford to forego interest on their deposits. Moreover, our banking standard has not attained so developed a form as can dispense with interest or reduce it, to an appreciable extent, without choking the flow of new savings.

The cheap money policy indirectly precipitated a boom in the Stock Exchange. With a gradually lower yield on Government securities, there was a perceptible tendency towards investments in stocks and shares giving higher returns. Thus while the Government were trying to neutralise the surplus spending power by cheap borrowings, they definitely encouraged the diversion of investible funds to stocks and shares whose yield was higher than the yield on Government securities. As a result the cheap money policy lost its efficacy in the whirlpool of two opposite forces. It has been rightly said that the cheap money policy is a failure in India, as it transpires that there was neither a low borrowing rate for the business men, nor was there any stimulation of productive activities. At the present moment business enterprise is being held up on account of lack of capital goods and a cheaper money will hardly improve the position. In India the money market and the capital market are not well-integrated and closely correlated.

The influence of cheap money is felt mostly in the organized section of the money market, of which banks are the chief components. The cheap supply of money in the organized money market has made but a little difference to the supply and cost of capital to small traders, business men and manufacturers. With the cessation of hostilities, the Government withdrew from many spheres of business activities and allowed private enterprise to resume operations in those spheres. Naturally, the short-term money market was severely strained as finance had to be raised from the said money market to fulfil decontrol, disposals and free movements of goods and capital resources. Such a state led to the hardening of the interest rates and hampered the success of the cheap money policy. In the industrial sphere there is no lack of finance, as internal finance and excess profits tax refunds meet the immediate needs of industries for liquid capital. But the bottlenecks are—the scarcity of capital goods, technical personnel, unsatisfactory industrial relations and absence of a comprehensive and co-ordinated industrial or economic policy. So while production is gradually declining in view of the aforesaid bottlenecks, it will be unwise to complicate the situation by generating inflationary conditions by pursuit of the cheap money policy. It will rather be advisable to check inflation by controlling the money factor.

Mr. Chintaman Deshmukh, the ex-Governor of the Reserve Bank of India, made the following observations on the continuance of the cheap money policy:

> "An aspect of war-time monetary policy which is likely to have a crucial significance for the future is that of cheap money. In India also during the years of the war, barring seasonal and regional fluctuations, the rates of interest on Government borrowings have steadily declined, although at the same time it is true that the benefits of cheap money have yet to percolate to the same extent to the other sections of our economy, particularly agriculture. The war-time expansion of currency against the accumulation of sterling and the unprecedented growth in bank deposits combined with the absence of suitable channels of investments and the imposition of controls over capital issues have helped to bring down rates of interest on both long and short-term

borrowings and Government have been able to raise about Rs. 1,200 crores at 3%. The Government of India have utilised this favourable position to plan the conversion of the 3½% Rupee paper and the latest floatation of Government has been a 15-year loan raised at 2½%. On the question of further advances in the direction of cheap money, opinion in the countries seems divided between maintaining and consolidating the progress so far achieved and taking it further with perhaps a fair degree of unanimity against any reversal of the trend. Cheap money is essential, apart from the advantage to government borrowing, for the purpose of stimulating investment in the private sector in the country's economy embracing the various forms of commercial, industrial and agricultural enterprise. It is, however, necessary that in its application to the different countries it should be differently adopted and the pace of its progress will have to be tempered to suit the conditions peculiar to each country. In India, which is economically backward, the percentage of savings to the total national income and the total available savings for investments are proportionally smaller than in the more mature industrial economies and enforcing a given rate of interest will need, therefore, a much greater degree of interference with the market forces and the controls and restrictions would be much larger in their scope and intensity than those in the advanced western countries. For want of an efficient administrative machinery in the context of the loosely knit economy of India, controls have been far from successful during the war, and have led to charges of inefficiency and corruption from the public. Further, as I stated earlier, in our country cheap money has yet to percolate to the other sections of *economy for consolidating the progress that has already been made.*"

There is a consensus of opinion amongst the economists and bankers that the policy of cheap money has been pushed too far and the time has come when it should, for the time being, be discontinued until the economic conditions of the country are stabilized. Recently there seems to have been a reversal of this policy. Effective from 15th November, 1951, the Reserve Bank has, with the concurrence of the Central Government, raised the bank rate from 3% to 3½% with a view to curbing inflationary credit condi-

tions and has decided not to purchase securities from banks for the time being. Subsequently, it has been raised to 4%.

With the raising of the Bank rate a dear money policy was initiated. With a view to making the new monetary policy effective, a fundamental change was made in the policy regarding provision of funds by the Reserve Bank to meet the requirements of the scheduled banks during the busy season. Simultaneously with the raising of the Bank rate, the Reserve Bank announced that during the ensuing busy season, it would, except in special circumstances, refrain from buying Government securities to meet the seasonal requirements of scheduled banks, but would, as a normal practice, advance money at the prevailing Bank rate on Government and other securities specified in Section 17 (4) (*a*) of the Reserve Bank of India Act. Thus the scheduled banks were not able to provide themselves with funds during the busy season by selling to the Bank Government securities in their portfolio and, as a result, the market was not in a position to augment money supply freely even in the midst of inflationary pressures, a phenomenon which had been witnessed in most other countries, including the U.S.A., where interest rates were pegged at the comparatively low levels established during the war in pursuance of the policy of cheap money.

The immediate effects of the new monetary policy were a hardening of the structure of interest rates and a stoppage of the automatic expansion of liquidity in the system through the Reserve Bank's purchase in the open market.

Against the background of rapid economic development initiated by the Five-Year Plans, opinions have been expressed in certain quarters that a lower Bank rate, by cheapening the cost of borrowing, would be more conducive to the needs of an expanding economy. Such an argument has some force in it but it loses sight of the long-term aspect of the problem. Increased spending in the wake of the Five-Year Plans will lead to an increase in the resources of the banking system which, if not properly regulated by various means of controls, may generate heavy inflationary pressures. In order to prevent the growth of such an economic maladjustment, a dear money policy is an essential prerequisite to the success of economic planning in India.

CHAPTER IX

CO-OPERATIVE BANKING AND AGRICULTURAL CREDIT

The measures for the rehabilitation of the co-operative movement in India have been discussed elaborately by the Agricultural Credit Department of the Reserve Bank of India in several bulletins issued from time to time. Some indications as to the lines of improvement have been given by us in the previous chapters. In this chapter we shall be dealing with some of the essential features of the existing form of co-operative banking which is one of the constituents of the money market in India.

If the position of the village credit societies is reviewed, it will appear that deposits from members constitute a small part of their total resources. In 1940-41 member-deposits formed only 40% of the total working capital of the agricultural credit societies. Naturally it will not be difficult to understand that because of the inadequacy of lending resources, the credit supplied by the agricultural societies cannot claim to be sufficient. The village societies are, therefore, left with the alternative of replenishing their resources by borrowings from the Central and Provincial Co-operative Banks. As a result, these societies cannot stand on their own legs and always have to depend on the crutches of help provided by the Central Banks. The position of such societies which remain indebted always to the Central Banks, is like that of 'societies in hospital'. In 1940-41 out of a total working capital of Rs. 30·53 lacs owned by the agricultural societies, more than Rs. 15·31 lacs was provided by the Provincial and Central Banks. If these credit societies are to be made self-helping and self-supporting, member-deposits should be sufficiently increased to provide adequate credit to the agriculturists. Next, the credit societies should grant loans only for productive purposes, whereby the repaying capacity of the borrowers is sufficiently augmented. "In India," says Mr. Calvert, "the distinction has to be, not between productive and non-productive so much, as between

necessary and unnecessary purposes." In India no systematic efforts have been made to ascertain the normal credit requirements of the cultivators for maintenance and expenses of cultivation. The average annual short-term and medium-term credit requirements of an agricultural family in Bengal have been estimated to be Rs. 160/- by the Bengal Banking Enquiry Committee, whereas even during prosperous years the average annual credit per member given by an agricultural primary society did not exceed Rs. 36·6.

The agricultural credit societies, whose deposits are short-term, must not invest them for the provision of long-term finance. They should provide mainly short-term and medium-term finance. The main asset of a co-operative society is to be "the funded honesty of its members." Any lending policy, based on the material security in disregard of the character of the borrower, will not produce the desired results, as adequate insistence should be put on the fundamental principles of self-help, thrift and honesty. Next to this, there should be a proper enforcement of repayment. "Unless loans are repaid punctually," wrote the Maclagan Committee, "co-operation is both financially and educationally an illusion." In 1936-37 about 50% of the loans of agricultural societies remained outstanding. The following figures are eloquent: (1936)

Name of place	Outstandings (lacs of Rupees)	Overdue (lacs of Rupees)	Percentage of overdues and outstandings
Madras ...	351·99	162·07	46·1
Bombay ..	247·36	128·24	51·8
Bengal ...	396·39	345·80	87·4
U. P. ...	75·91	36·21	47·7
Bihar ...	104·18	96·40	92·5

Thus it will be revealed that most of the agricultural societies lie in a state of suspended animation. The problem is to unfreeze the movement and to reopen the stream of credit wisely. Credit dispensed should be adequate to prevent outside borrowing by members. This outside borrowing by members can be prevented by (*a*) the adoption of full finance by the credit societies, (*b*) the immediate expulsion from the society of any member who is

found to have borrowed from outside sources, (*c*) the control of money-lenders, and (*d*) the creation of a first charge on the produce of members' holdings in favour of the agricultural credit societies. The supply of credit by the village credit societies can be quickened by the following methods:

(*a*) the adoption of the system of forecast loans ;
(*b*) the introduction of cultivation cash-credits ;
(*c*) the prompt disposal of loan applications by the Central Banks and Provincial Banks.

Central Banks

The Central banks have three important functions, *viz.*, (*a*) they finance the primary societies in the area of their jurisdiction, (*b*) they act as balancing centres for the primary societies, (*c*) they undertake the supervision of their constituent primary societies. In addition to these, the Central Banks issue, purchase, sell bills of exchange or hundis. In some provinces they make godown advances.

The working capital of the Central Banks is raised from (*a*) share capital, (*b*) reserve funds, (*c*) deposits from members and non-members, and (*d*) loans from provincial co-operative banks, other central banks, and joint-stock banks. The achievements of the Central Banks have been aptly described by the Madras Committee on Co-operation:

> "The Central Banks have served their purpose of financing rural and urban societies and balancing their funds admirably well ; they have mobilised local deposits and made them available to primary societies at reasonable rates of interest and have rendered great service in the organisation of agricultural finance on co-operative lines ; they have drawn into the movement a number of honorary men whose services have been invaluable to the progress of the co-operative movement ; they have taken a genuine interest in the growth of the movement in their respective areas and in schemes of co-operative education and rural development generally ; they have enlisted the sympathy of an increasing body of depositors, and, as a rule, have justified the confidence which the depositors have reposed in them."

But the policy of the Central Banks is not free from defects. While granting credit to primary credit societies, the Central Banks do not always carefully examine the creditworthiness of those societies. The task of verification of credit is left to the supervisor, who cannot do proper justice to the job in view of the fact that he is to ascertain the property and debts of six to seven hundred members, on top of his other duties. The Central Banks are found sometimes making a curious amalgamation of long- and short-term loans, of which long-term loans stand high. As pointed out by Dr. J. P. Niyogi, "instalments have been fixed with reference to the borrowings for long-term purposes even when the cultivators have applied for loans for such divergent purposes as cultivation expenses and the purchase of lands." The Central Banks have since resolved to confine their activities to short-term loans. In many cases it has been found that the Central Banks have acted quite contrary to certain fundamental principles. As for example, reserve funds, which according to principle are inviolable, have often been utilised by the Central Banks as working capital. As a result the liquid position of many of the Central Banks was seriously impaired. It is essential that the reserve funds should be separated from the normal working capital and invested outside the movement as a bulwark of defence in times of emergency. The Central Banks were hard hit by heavy outstandings and overdues, aggravated by a shrinkage in the income of the borrowers on account of the slump in agriculture. The position may be retrieved to a certain extent by the observance of a cautious lending policy, the application of co-operative and banking principles and the adoption of effective supervision by the Central Banks.

Provincial Co-operative Banks

The functions of the provincial co-operative banks are fourfold:

(*a*) they act as bankers' banks to the Central Banks in the districts ;

(*b*) they form the connecting link between the money market and the co-operative movement ;

(*c*) they ensure co-ordination of effort and uniformity

debts.........Amongst the objects of the land mortgage banks will be included the improvement of agricultural lands and methods of cultivation. All loans to members of land mortgage banks will be secured on the mortgage of agricultural land and the bulk of working capital will be obtained by the issue of debentures secured on the mortgage. The Government of Madras undertook to subscribe to half of the issued debentures within a limit of Rs. 2½ lacs. The Townsend Committee on Co-operation examined in 1927-28 the position of the land mortgage banks and recommended the formation of a Central Land Mortgage Bank. Accordingly a Central Land Mortgage Bank was started in December, 1929 in Madras with a view to co-ordinating the activities of the small land mortgage banks whose number will now exceed 100. The Madras Co-operative Land-Mortgage Bank Act, 1934, empowers the Local Government to guarantee the debentures of the Central Land Mortgage Bank and removes certain legal disabilities of the Bank in its successful working.

The Bombay Provincial Co-operative Land Mortgage Bank was registered in 1935 with an authorised capital of Rs. 10,00,000 having under its control over 13 primary land mortgage banks. The Provincial Land Mortgage Bank grants loans to agriculturists through the primary land mortgage banks on the security of their lands. The primary banks have to investigate the title to lands, income and the repaying capacity of the agriculturists. The maximum amount of loan permissible to a single borrower is restricted to Rs. 10,000 and the maximum period of loan is for 20 years only. In Bombay the objects of a primary land mortgage bank are (*a*) to promote the economic interests of its members and more particularly to advance loans to its members on the security of mortgage of immovable property; (*b*) for the redemption of mortgaged lands, houses and liquidation of old debts of agriculturists; (*c*) the improvement of the agricultural land and for adopting improved methods of cultivation; (*d*) the installation or purchase of costly agricultural plant and machinery; (*e*) the purchase of land for the purpose of improvement or more economic cultivation of the existing holding or for bringing under cultivation cultivable wastes; (*f*) and to encourage in the members the spirit and practice of thrift, self-help and mutual aid in such a way as may be practicable from time to time.

The scheme for the establishment of land mortgage banks in Bengal took a definite shape from the recommendations of the Bengal Banking Enquiry Committee. Accordingly five land mortgage banks were started in 1934-35. The primary land mortgage bank was subject to two restrictions on its borrowing powers:

1. that it will not exceed twenty times the paid-up share-capital plus the reserve fund, and
2. that the amounts borrowed shall not exceed 50% of the value of the land mortgaged.

Its lending policy was likewise subjected to the following limitations:

1. No member is allowed to borrow exceeding the limit of Rs. 2,500 which may be raised to Rs. 5,000 in special cases.
2. Advance of more than 50% of the market value of the land mortgaged is not permissible.
3. A person who is a member of any other co-operative society cannot borrow from the Co-operative Land Mortgage Bank unless his application is recommended by such co-operative societies and also by the Central Bank to which that co-operative society is affiliated.
4. The primary society is authorised to grant loans only on first mortgages.

25% of the net profits should be transferred to the Reserve Fund. A Redemption Fund has been instituted to pay off the debentures on the expiry of thirty years from the date of issue. When the business of these banks will sufficiently grow, the question of starting a Central Land Mortgage Bank may be taken up. In Bengal the business of these banks was largely facilitated, as they were given the privilege of recovering their dues by certificate procedure. But in Bengal improvement in another direction is necessary. Here obstacle to the transferability of holding should be removed in order to enable the land mortgage bank to put to sale any mortgaged property.

Measures of Reform and Caution

I. Proper valuation should be made of the land proposed to be mortgaged as security for loans from the land mort-

gage bank. In France advances were made for a long time on the basis of the valuation given in the *Cadastre, i.e.,* a valuation made for the purpose of the assessment of the land-tax, which is now obsolete. So this method had to be abandoned at last. In Germany also valuation was made in accordance with the valuation made for purposes of fire insurance. This method is also defective. So in fixing the value of the land, the probable outturn of crop, average price of crop and cost of production should be taken into consideration and "that valuation should be checked in the light of the price fetched for similar lands in the neighbourhood and also the price realised for similar lands at reverse sales."

II. A clear-cut segregation should be made between the short-term finance of rural credit societies and the mortgage finance of land mortgage banks so that the latter may be controlled by a centralised organisation called the Central Land Mortgage Bank.

III. Extravagant loan policy should be carefully discarded. The stagnant position of land mortgage banks in the Punjab is a serious pointer to the dangers of a liberal loan policy without taking account of the income position of the borrowers.

IV. Legal difficulties in bringing to sale the mortgaged lands as interposed by the Land Alienation Act should be removed. It is necessary to realise that successful working of a land mortgage bank largely depends on the removal of those legal difficulties which prevent the banks from exercising the right of sale of the mortgaged properties.

V. In the present stage of experiment the rate of dividend should be reduced. The policy may be revised when sufficient reserves are built up.

VI. The loan applications should be carefully examined and scrutinised from all respects and the loan should be fixed as will be well within the repaying capacity of the borrowers.

VII. Plan should be chalked out to repay the debentures within a certain time, for which purpose redemption fund or amortisation plan be created.

VIII. Dr. J. P. Niyogi holds the opinion that there are special considerations which render it imperative that the mortgage banks in India should confine themselves to businesses which are intermediate in duration between the short- and long-term loans as prevalent in Europe and America...... Nor must we ignore the consideration that an extension of the period of the loan increases the risk of litigation amongst the heirs of borrowers. It is, therefore, desirable that risks of this kind should be avoided as far as possible.

IX. Constant attention should be devoted to the realisation of outstandings.

VILLAGE BANKS

The Reserve Bank of India published a valuable bulletin about the working of the village banks. In that publication the Reserve Bank of India recommended the expansion of the activities of those village banks in five directions:

1. "The bank must take up the whole of the village life within its ambit ;
2. it should aim at including everyone in the village ;
3. there must be a greater adherence to co-operative principles ;
4. there must be constant dealings and continuous touch with the members ; and
5. concentration on a few selected areas should be aimed at rather than wide multiplicity and diffusion."

The village bank should not simply rest content with the supplying of credit, but must help the agriculturists in the marketing of their produce, assist them in getting necessaries of life at cheap price, create interest in them in industrial and agricultural developmental works, and convert itself into a potent and healthy force influencing the harmonious development of the co-operative village life and teaching them the principle of "better living and better farming and better business." The village banks must embrace everyone forming a part of village economy, such as "the grower of food, the blacksmith, the carpenter, the dealer of hides and skins etc." The bank should promote in the villagers the habit of thrift and prudence and mobilise their idle hoards, if any.

It must see that the credit available to a villager is put to productive purposes. It must further help in the dissemination of co-operative principles.

The village bank may help the farmer in purchasing better seeds, better manure or fertilizers, better tools and cattle. It may encourage joint farming in the village and finance such co-operative farming, if necessary, and improve the irrigation facilities by the sinking of wells or repairing of tanks. It is further suggested that the members should be encouraged to conduct their business through the bank, getting their requirements and selling their produce. Sale proceeds must be deposited with the bank and paid out only as required. This will result in controlled expenditure and avoidance of wastes.

But it is doubtful whether the village bank will be able to discharge all these functions at a time. It is asking the village bank to do the impossible. Rightly has it been pointed out that the task of marketing, which is a technical and specialised function, cannot be safely entrusted to the village bank or to the rural credit societies. What is needed to-day is more of co-ordination than of combination of diverse functions in a single institution.

Indigenous Banking

The system of indigenous banking in India is of long standing. It is usually found exclusive to some important castes of Hindus like the Marwaris, Jains, Multanis and the Natlok Kotin Chetty etc. Indigenous banking prospered much after the 1st century A.D. and established itself firmly in the fourth century A.D. During the Mohammadan rule the indigenous bankers obtained a strong foothold due to royal patronage, and the extent of such royal patronage can be gauged with reference to the house of Jagat Seth during the 17th and 18th centuries. But after the establishment of British rule in India these indigenous bankers lost their pre-eminence gradually. But still their influence has not waned so much as is imagined to be. Even to this day these indigenous bankers supply 90% of rural credit. They have stood the test of centuries, notwithstanding political convulsions, revolutions and sweeping changes. It will not be wrong to say that indigenous banking has become an institution, which is built on

the commercial and financial genius of the people, their local requirements, habits, customs and traditions and is praiseworthy for the close personal contacts with the clientele and the simplicity and inexpensiveness of the methods of work. These indigenous bankers possess intimate knowledge of the local conditions and the local clientele and as such have served usefully as links between the vast trading community and the modern banking institutions. Their position may, without exaggeration, be compared to that of the bill-brokers in the London money market, whose services are invaluable in respect of the negotiation of bills of exchange.

There are few indigenous bankers who carry on the business of banking alone. The majority of them combine banking with trading. In centres round Bombay and Central India they deal largely in cotton, seeds and operate as commission agents as well. Such a combination of banking with trading is no doubt unjustifiable from the standpoint of modern banking principle, still there are certain strong points of argument in favour of such practice. The Bengal Banking Enquiry Committee justified it on the following grounds:

> "The personal relations which grow out of trade have to a great extent been responsible for making the function of banking attractive to the trader, as such relationships help him to turn his surplus to good account. The lending operations undertaken by him have furthered the indirect, and no less important, effect of securing an advantage in his trading business, because the loans made to the producers bind them to the lending trader by a tacit or explicit understanding to sell their produce to him. Lastly, the banking business is of permanent importance to the trader in the remittance of his funds and collection of his dues."

These indigenous bankers finance the internal trade by remitting funds from place to place through the instrumentality of hundis, and sometimes by discounting these hundis. In Bombay, a considerable volume of hundi discount is made by the Multani Shroffs, who have specialised in this type of business for a long time. They seldom deal in foreign bills and mostly confine their activities to the discounting of inlands bills. These Multanis command so much reputation for their business acumen and foresight

that if they refuse to discount any hundi, that is considered as a warning to the market operators. These indigenous bankers, in addition, are in the habit of lending money on the growing crops and ultimately purchase the crops themselves. Sometimes they finance shopkeepers by honouring hundis drawn on the latter for which certain percentage is charged as commission. More often these bankers or shroffs take delivery of goods on behalf of their customer-merchants living in the mofussil by paying at the principal ports and recover their money thereafter. Sometimes they advance money to local cottage industries, small factories and lend money on deposit to the mill industry, particularly textile industry. Mostly these indigenous bankers carry on business with their own resources and hardly do they receive funds from others. But a limited number of them receives deposits from others and issues cheque books and pass books to the depositors. These cheques are mostly drawn in the form of hundis payable on demand rather than in the standardised cheque forms. These indigenous bankers may help considerably in stimulating the habit of thrift and banking amongst the rural people who live so far away from the sphere of modernised banking.

Indigenous Banking in Bombay State.—The indigenous bankers of Bombay State perform all the functions of ordinary banking including acceptance of call, fixed deposits, maintenance of current accounts, compliance with the written instructions of the account-holder, advancing of loans on security or without security, discounting of hundis and bills and financing of inland trade through their agencies or offices in different places. These bankers establish business relations with those customers, whose family history and traditions are well known to them. Such a position is analogous to the old English private banking system, which fostered banking habit amongst the different customers and ultimately paved the way for the evolution of deposit banking on modern lines. As usual, these indigenous bankers combine trading with banking and keep their books of account on the primitive system, which naturally precludes the possibility of any expansive business.

Loans which are repayable on demand are entered in *Chalu Khatas, i.e.*, on current accounts. When loans are not repayable on demand but payable after a certain period, these are known to

be *Khatapeta*. When money is borrowed for a fortnight, the account is known to be *Bijoy badala* and temporary loans granted for a day or two free of interest or without promissory notes are called *inter-shroff transactions* popularly known as *Hathudhar*. Besides dealing with other shroffs, village money-lenders and other traders, the shroff finances cottage industries and other small industrial concerns like flour mills, rice mills, gold-thread industries, etc. The shroff industry helps the agriculturists by loans granted to sowcars, who, in their turn, advance money to the cultivators on the crop or seeds and for other agricultural purposes. The advance by the shroff is made either in the form of a loan or Khata account or by discounting darshani hundis accompanied by railway receipts. In most cases the shroff acts as a commission agent. He pays in advance to his constituent 75 to 90 per cent of the value of goods against railway receipts, the balance being adjusted on sale of the goods. The value of the purchase of one consignment is set off against the sale of another through the same shroff. The shroffs, in their turn, replenish their resources by rediscounting their bills or hundis with other joint-stock banks or the erstwhile Imperial Bank of India. The Multani shroffs very often do enjoy rediscounting facilities from the erstwhile Imperial Bank of India which prepares a list of such approved bankers. The usual period of such advances varies from thirty days to sixty days.

Indigenous Bankers in Bengal.—Most of the indigenous bankers of Bengal are Marwaris, who combine banking with trading. The Bengal Banking Enquiry Committee did not look down upon the combination of banking with trading, as it is peculiar to these indigenous bankers, but considered it to be a special form of banking evolution suitable to the conditions of the country. There is not so much objection to this sort of mixed business as to the admixture of banking and trading accounts instead of their segregation. These indigenous bankers of Bengal do not receive deposits from others but trade on their own funds. In Bengal there existed not less than 1200 "loan offices" registered under the Indian Companies Act, which attracted deposits and also carried on trading business and as such they were formidable competitors of these indigenous bankers. These indigenous bankers of Bengal financed inland trade by discounting *hundis* or *purjas*, or by entries in account books called hatchitas, khatapetas and khatamitis. These were

largely the commercial loans granted on personal credit to the merchants who went into the interior for the purchase of produce or gathered local products for export. In such cases of advance, it is arranged that the merchants will be remitting the whole of the daily sale proceeds to the bankers for credit to the running account. The system of accounting in such cases is called *Khatamiti*. Sometimes they lend money on pledge of jewellery or mortgage of land or on guarantee of a third party.

These indigenous bankers of Bengal issue hundis for the purpose of raising loans, financing trade and for remittance of money from one place to another. There are darsani hundis, *i.e.*, hundis payable on sight and usance bills called Mudati hundis. The rate of discount of these hundis is known as *hudiana*, which varies from 4% to 18% according to the conditions of the money market. These bankers obtain rediscounting facilities from the erstwhile Imperial Bank of India or other joint-stock banks against these hundis.

Indigenous Banking in Madras—The Nattukkottai Chettis do the bulk of indigenous banking in Madras. These bankers receive deposits and afford cheque facilities. The deposits of these bankers are estimated by the Banking Enquiry Committee of Madras Presidency to be Rs. 25 crores and their investments are reported to have exceeded Rs. 50 crores. These chettis are exceedingly solvent people and possess shrewd banking acumen. They have a peculiar system of training their managers and agents through apprenticeship coupled with an agreement to serve their masters on completion of their training course. They do not lend largely on produce but make advances to agriculturists on land and promissory notes. They use hundis like *Darsani* hundis, *Nadappu Vaddi* hundis etc.

A small number of Multanis act as intermediaries between merchants and joint-stock banks. They advance money during busy season and replenish their resources by borrowings from the erstwhile Imperial Bank of India. Mainly do they transact business with their own resources and occasionally do they receive deposits from others under certain arrangements. The Marwaris have an extensive banking business in the State by making advances on the security of produce, ornaments, hundis etc., but they usually refrain from financing the small industries of the State. The rates

of interest charged are comparatively high, so also the rates of discount on hundis.

There is another community of indigenous bankers called "Kallidai Kurichi Brahmins," who carry on business mostly at modern Ramnad, and Tinnevelly. They specialise mainly in hundi-business and issue from time to time drafts and other instruments on other private indigenous bankers.

On taking a retrospective view of things, it will appear that the indigenous bankers are rendering some useful services specially to the rural people, who would otherwise go without any kind of banking facilities. From the standpoint of profitability, it does not pay any joint-stock bank to open any office in the rural areas. So the vacuum caused by the lack of banking facilities is filled to a great extent by these indigenous bankers who have evolved a unique method of operating with the greatest economy and simplicity. Moreover, in urban areas like Indore, Bombay, Ahmedabad and Calcutta they extend to the mill industry assistance by way of deposits, which help in swelling the working resources of the cotton mills, which are, in the present state of our country, mostly undercapitalised. Very often do these indigenous bankers or shroffs lend money to the managing agents of these mills in return for a share in the agency commission in addition to the usual rate of interest. Considering the wide range of the services rendered by these indigenous bankers within limited areas, it is considered that a little bit of modernised banking training could contribute to their usefulness. In Great Britain the so-called private bankers, who went more or less akin to our indigenous bankers, played an important role in the development of banking in that country until they were absorbed, by proper arrangements, by the present joint-stock banks. These private bankers fostered, to a great extent, the banking habit amongst the people, specially in the countryside and villages, where banking facilities are hopelessly inadequate. If these bankers take a wider interest in the methods of modernised banking and bring those to bear on their policy they may make themselves more serviceable and useful to the rural community. Besides developing a receptivity to new ideas they should try to standardise the form of hundis which at present have confusing varieties and are attended with differing multiplicity of practices, so that certain uniformity in their working

methods is established throughout the different parts of the country. In our opinion, the different Shroff's Associations may help in this matter.

Need for Co-ordination between Indigenous Banking and Modern Banking

It is now widely felt that in order to mobilise the capital resources of the country in an effective manner and to establish a unitary control over the credit structure of the country, indigenous banking system must have to be co-ordinated with modernised joint-stock banking. The need for such a co-ordination was stressed by Sir George Schuster in the course of his speech on the Reserve Bank Bill (1933) in unequivocal terms. "Until the vast portion of India's banking and credit machinery, which is represented by the indigenous bankers," says he, "is put into gear with the relatively small machine of the modernised money market, with the Reserve Bank as its central control, it will be impossible for the Reserve Bank to exercise full control of currency and credit of India, which is understood as the function of the central bank in western countries, and it will be equally impossible for the masses of the people who populate the countryside of India to get the full benefits of credit and banking facilities on reasonable terms, which a well-organised system of banking ought to give." The Central Banking Enquiry Committee made some valuable suggestions for the indigenous bankers. Later on, it was suggested that instead of dealing directly with the indigenous bankers, it would be more advisable to deal with them through the intermediary of scheduled banks, because of the personal character and fluid nature of their business. Under the provisional scheme the shroffs were to get their bills and notes discounted with the scheduled banks, which, in their turn, were to get those documents rediscounted with the Reserve Bank of India. At the same time the Reserve Bank laid down certain conditions precedent to the establishment of a direct link with those indigenous bankers. Among other conditions, the indigenous bankers were to organise themselves into self-contained legal entities with at least Rs. 5 lacs of their own capital like scheduled banks, maintain compulsory deposits with the Reserve Bank, segregate their banking from non-banking business, and

maintain properly audited accounts. These conditions of the provisional scheme were considered to be too onerous and accordingly a second draft scheme was prepared by the Reserve Bank which enumerated the following conditions:—

(*i*) They must confine their business to banking proper as defined by the Indian Companies Act. Any other business that they might be conducting should be wound up within a reasonable period.

(*ii*) They must maintain properly audited books of accounts and allow the Reserve Bank to inspect the accounts and call for any information necessary to determine the financial status of these bankers.

(*iii*) They must file with the Reserve Bank periodical statements which are required of scheduled banks.

(*iv*) Indigenous bankers with owned capital of Rs. 2 lacs, which might be raised to Rs. 5 lacs at the end of five years would be entitled to apply for registration in the books of the Reserve Bank as private bankers. They would not have to furnish compulsory deposits unless their time and demand liabilities are five times or more in excess of their capital in the business.

(*v*) The Reserve Bank will have the right to regulate the business of these bankers on banking lines when necessary.

If they satisfy the above conditions, they will have the privilege of rediscount with the Reserve Bank against eligible paper, the right to secure advances against Government papers, and have remittance facilities similar to those for the scheduled banks. But the indigenous bankers disagreed with most of the recommendations and considered those conditions as too hard. The Reserve Bank did not agree to modify these conditions but kept the offer still open to the indigenous bankers. Thus the question of the linking of the indigenous bankers with the Reserve Bank remains in a melting pot and it is felt that such a stalemate should not be allowed to continue further. Some solution must have to be made of this knotty problem. Both sides should yield ground to a certain extent to arrive at a happy agreement. The Reserve Bank of India should realise the difficulty in effecting overnight a revolutionary change of the methods of indigenous banking, which has attained the present form through centuries of working. It is asking too much

of them to wind up trading business and develop the side of deposit banking within so short a time. Moreover, it has been pointed out by some Provincial Banking Enquiry Committees that the combination of banking with trading, as made by the indigenous bankers, is not unsound, but it is a special form of banking evolution suitable to the conditions of the country. These bankers have specialised in this form of banking on lines of safety. So to ask them to discard this form of business means the abolition of the indigenous banking system. On the other hand, the indigenous bankers should likewise appreciate the desirability of the improvement of their methods and technique of business in the light of recent banking experiences and should be educated to give proper value to audited statements of accounts, which will raise their status in the estimation of the public. Audited statements of accounts do not mean disclosure of their business accounts. So they have little to be afraid of. However, if it is considered to be difficult, in the present fluid circumstances, to link them directly with the Reserve Bank, the alternative proposal of indirect linking through the intermediary of scheduled banks may be given a fair trial. It is admitted that the joint-stock banks do frequently discount the hundis and promissory notes of the indigenous bankers in their approved list, and long-standing business relationships with them help the joint-stock banks to keep up-to-date information about their credit, means and integrity. It is expected that the joint-stock banks will be restricting their business dealings to those indigenous bankers, who are safe businessmen and have established reputation. So, as these indigenous bankers come into closer business contact with commercial banks, the task of the Reserve Bank in the selection of the approved indigenous bankers is simplified through the help of these commercial banks discounting the documents of the selected indigenous bankers, and the purpose of direct dealings with these bankers may thus be indirectly served. As most of these commercial banks gather up-to-date credit reports about these indigenous bankers, those may be passed on to the Reserve Bank for their information and the Reserve Bank may verify those statements by independent enquiries, if necessary. So, in our opinion, the more and more do these indigenous bankers feel persuaded to transact business with the commercial banks, the simpler will be the process of their linking with the Reserve Bank.

It will not be very wrong to say that these indigenous bankers, by acting like discount houses in England, will help in the formation of a bill market in India, which is so vitally indispensable for the healthy development of banking in our country. In this connection Sir Benegal Rama Rau, Governor of the Reserve Bank of India, while addressing the All-India Shroffs' Conference on July 21, 1951, made the following observations:

"I have, on several occasions, emphasised the importance of a wide extension of credit facilities in the country, which are essential for rapid economic development. I can assure you that the Reserve Bank will be very pleased to see the indigenous bankers play their full and honourable part in the credit machinery of the country, but, as you will all appreciate, the primary responsibility for producing a constructive scheme for the linking of the indigenous bankers with the Reserve Bank must rest on the indigenous bankers. To facilitate any such development, you should be prepared to change your traditional outlook and practices and adapt your methods of working to modern conditions. As many of you are probably aware, the Reserve Bank is undertaking a comprehensive enquiry into all aspects of rural finance. One of the objects of this factual investigation will be to ascertain the position which the indigenous bankers in different parts of the country occupy at present, their business methods, their financial resources, their scale of operations etc., with special reference to the part they have played and are playing in meeting the credit requirements of rural areas. I hope that in this important investigation we shall have the full co-operation of the organised indigenous bankers in the collection of all the necessary data for, as you all realise, it is only on the basis of ascertained facts that we can evolve any constructive proposals." (Sir Benegal Rama Rau). The Committee on Finance for the Private Sector has recommended that the question of linking indigenous bankers and shroffs should be actively pursued by the Reserve Bank of India in consultation with the Shroffs.

AGRICULTURAL FINANCE

India being pre-eminently an agricultural country, the problem of agricultural finance is one of the highest priorities in our national

economy. The main difficulties in provision of agricultural credit have been discussed in chapter I. In India agriculture is looked upon not so much as a profession but as a mode of living. Naturally it is characterised by the uncertainty of profits. In an industry which does not hold out any possibility of profits, no investor will hazard investing money. This uncertainty will engender a psychology of living for the day and an aversion to thrift and saving, which will naturally dam the flow of credit to agriculture. The question of agricultural finance is closely linked up with the question of improvement of agriculture. If credit is to flow to agriculture, the agriculturists have to be made creditworthy. As at present the following agencies supply agricultural credit:

(1) Commercial banks,
(2) Government,
(3) Indigenous bankers and money-lenders,
(4) Co-operative Credit Societies.

Commercial Banks.—Having regard to the short-term nature of their deposits, commercial banks cannot extend credit for a long term to agriculture. Naturally, these banks cannot go beyond financing the seasonal movements and marketing of crops by making short-term advances against produce. But there are certain items of permanent agricultural improvements, which require long-term investments which the commercial banks cannot undertake. The commercial banks, with a few exceptions in certain parts of Southern India, have no direct relation in respect of marketing of produce, with the actual cultivators ; but in other parts of India "their role in agricultural credit is usually that of an intermediary furnishing part of the credit to the indigenous banker and in a small degree to the landlord or the co-operative banks." But in England the large bulk of agricultural credit is provided by the commercial banks. The Committee on Agricultural Credit in England (1923) observed that the "Big Five" in England and Wales had outstanding agricultural loans to the extent of £46½ million, of which £20 million represented loans for the purchase of agricultural land and £20 million normal loans for current trading. In America also the farmers obtain regular credit from the State and national banks for the marketing of their crops. There a considerable portion of agricultural credit is supplied by the commercial banks. But in India the commercial banks, for the sake of safety, cannot participate

largely in the supply of agricultural credit, because of the defects of the agricultural occupation. Here the commercial banks may extend credit for seasonal operations if there exist a proper grading and standardisation of staples and of contract, proper storage facilities and properly regulated local as well as forward markets. But still there is sufficient scope for the expansion of the agricultural credit on the part of the commercial banks, to the money-lenders, indigenous bankers and co-operative banks, provided they reorganise themselves, and the benefit ultimately tends to percolate to the tillers of the soil. It cannot be doubted in the last that if direct extension of credit to the farmers were possible that course would have been the best.

Government also finances the agriculturists often with takkavi loans. But in view of the smallness of the amount of such loans, the agriculturists do hardly obtain any substantial relief. Moreover, these loans tide the agriculturists over emergencies only and do not serve as sources of normal finance. By its very nature the Government machinery is unsuitable for supervising the use to which these loans are put and it frequently happens that these loans are never put to any productive purposes by the farmers. Experience shows that sufficient advantage has not been taken of loans under the Land Improvement Loans Act. Loans under this head should preferably be given and supervised by land mortgage banks on business lines. *What is required from Government is not so much actual loans to cultivators as an active and progressive agricultural policy.*

The money-lenders and indigenous bankers provide the bulk of agricultural finance. Their functions have been described fully earlier. Considering the exorbitant rate of interest charged and the various malpractices adopted by the money-lenders, which go to swell the indebtedness of the peasants, it has been recommended that money-lending should be regulated by legislation and registration of money-lenders be made compulsory. Further, it is suggested that a procédure should be devised for the inspection of the books of accounts of the money-lenders. Accordingly, legislative measures have been passed for the regulation of money-lending in almost all the states of India. Though such measures have, for the time being, led to the contraction of agricultural credit, it is expected that they will be able, in course of time, to

bring about a change in the outlook of the money-lenders which will convince them that they have nothing to lose from such enactments. The necessity for the linking of indigenous bankers with the Reserve Bank of India has already been discussed.

Co-operative banks commend themselves to be the most suitable agencies for supplying agricultural credit. But the progress so far achieved by these banks is not satisfactory. The total membership of the co-operative societies comprises only 1·06 per cent of the rural population. About one-third of these societies is in a moribund state and is classified as D or E societies because they are either not functioning properly or are on the verge of liquidation. The loans outstanding against members amount to Rs. 24½ crores, out of which three quarters are shown to be overdue. It is, therefore, necessary that these societies must have to be reformed in order to make themselves useful and for this purpose the long-term loans and overdues should be segregated and put on a proper footing, adequate reserves should be built up by these societies and future loans should be restricted to such sums only as could be reasonably expected to be repaid out of the harvest. The primary credit societies should be strengthened and imbued with a new idealism. "They must not be merely agencies for supplying finance but an influence for the all-sided development of agriculture and for the betterment of the life of the villager from every point of view." These societies should take up marketing of the produce of the members as well and supply to them agricultural seeds. They should be assisted to build up serviceable godowns not only for the purpose of storing produce but also for facility of collection. The central and provincial co-operative banks should re-organise their operations strictly on banking lines and establish closer connection with the commercial banks. The provincial and central co-operative banks will do well to have on their management some professional bankers who will be able to guide their operations strictly on commercial lines. The utility of the land-mortgage banks cannot be over-emphasised in relation to supply of long-term credit to the agriculturists. Investigations show so far that these land-mortgage banks devoted exclusive attention to the liquidation of the old debts of the cultivators. It will not be difficult to understand that the reduction of old debts alone will not contribute to the repaying capacity of the cultivators unless

they are properly educated to utilise those loans for productive purposes, whereby their agricultural pursuits are made profitable. The peasants must be enlightened about the productive use of money and if they are living on deficit economy, attempts must be made to increase the margin of their income as well as of profit. Advances merely on the basis of security without adequate knowledge of the character and habits of the debtors will minimise the utility of the land-mortgage banks. So it has been suggested by the Reserve Bank of India that "arrangements should be made for the person whose debt is to be paid by the land-mortgage bank to serve a period of probation with a good primary society and that even after the land-mortgage bank has advanced him a loan he should continue to be a member of the Multiple Purpose Society so that the regular repayment of his instalments may be ensured by proper supervision of his activities." The land-mortgage banks, in their zeal to afford relief to the agriculturists, must not lose sight of the fact that the main purpose of a long-term loan on the security of land should be the improvement of the land itself and they should see that the loans are utilised for effecting permanent improvements of the land. These banks should not hesitate to undertake finance for permanent improvements like the creation of bunds, the installation of power units, levelling, fencing etc., and encourage as far as possible consolidation of holdings. In this connection the land-mortgage banks should act in close co-operation and collaboration with the Agricultural Department of the Government. In short, the problem of agricultural finance can be successfully tackled if the entire co-operative movement is rehabilitated and conducted on right lines.

It will be relevant to discuss at some length the role which the Reserve Bank of India should play in agricultural finance. The Reserve Bank of India maintains an Agricultural Credit Department which is to investigate and study the various aspects of agricultural credit and to suggest from time to time ways and means for the improvement of the machinery for dealing with agricultural finance and methods for effecting a closer co-operation between agricultural enterprise and the operations of the Bank. The Reserve Bank of India has often been criticised for its failure to assist agriculturists by direct monetary help, and also for its lukewarmness in indicating the lines on which the Bank would be

prepared to grant such help. To understand the implications of this charge it is necessary to remember that the Reserve Bank of India is a lender of last resort and can never undertake to supply to the agriculturists their normal financial requirements or advance large sums to co-operative banks or indigenous bankers for being lent out to cultivators as a matter of course. The Reserve Bank of India can at best provide temporary financial accommodation in times of emergency and seasonal stringency. As it has been pointed out, it is no part of the functions of a central bank to provide directly day-to-day finance for banks and other institutions but rather to produce monetary conditions under which there will be adequate facilities for all those seeking credit for legitimate purposes or having funds to invest. Under Sections 17 (2) (b), (4) (a), (c) and (d) of the Reserve Bank of India Act, the Reserve Bank can provide financial accommodation to the provincial co-operative banks and through them to the co-operative movement under the following conditions:

(*a*) Loans and advances against Government securities for periods not exceeding ninety days to provincial co-operative banks and through them to the central co-operative banks.

(*b*) Similar loans and advances to provincial co-operative banks and through them to central co-operative banks against approved debentures of recognised land-mortgage banks which are declared trustee securities, and are readily marketable.

(*c*) Discount of Treasury bills.

(*d*) Loans and advances for periods not exceeding ninety days to provincial co-operative banks against promissory notes of approved co-operative marketing or warehouse societies endorsed by provincial co-operative banks and drawn for the marketing of crops—sec. 17 (4) (e) ; or rediscount of such promissory notes maturing within fifteen months—sec. 17 (2) (b) ; loans and advances for periods not exceeding ninety days on the promissory notes of provincial co-operative banks secured by warehouse warrant issued by corporations independent of the borrower or on the security of promissory notes supported by documents of title to goods which have been assigned or pledged

as security for cash-credits or overdrafts granted by the provincial co-operative banks to approved marketing or warehouse societies—sec. 17 (4) (d).

(*e*) Advances to provincial co-operative banks for a maximum period not exceeding ninety days against promissory notes of central co-operative banks endorsed by provincial co-operative banks and drawn for financing seasonal agricultural operations or the marketing to crops—sec. 17 (4) (e); or rediscount of such promissory notes maturing within fifteen months—sec. 17 (2) (b).

Before granting any financial assistance the Reserve Bank of India must be satisfied about the soundness of the applying provincial co-operative banks and central co-operative banks. It requires the provincial co-operative banks applying for accommodation (*a*) to maintain with it like the scheduled banks some minimum balances at 2½% of their demand liabilities and 1% of their time liabilities, (*b*) to recast their balance-sheets and to submit to the bank periodical statements prescribed for the purpose, and (*c*) to submit themselves to periodical inspection by the Bank. The Reserve Bank requires the central co-operative banks to submit to a number of conditions:

(1) it requires fuller information about the financial position of the central banks whose paper is intended to be rediscounted and the working of the primary societies financed by them;

(2) it wants them to keep 40% of their deposit liabilities in cash and Government securities;

(3) it wants the co-operative banks and village credit societies to confine themselves only to short-term financing. It further suggests that medium-term loans should not exceed two years and should form a comparatively small part of the total business.

The Reserve Bank of India has laid down so many conditions which are to be fulfilled prior to eligibility to credit, that it becomes an impossible task to fulfil all of them at a time. The maintenance of liquid resources up to 40% of the deposits would practically cripple the business and working of central banks. Moreover, as the co-operative banks are to advance on such low rate of interest, they cannot afford to lock up their funds in low-yielding Govern-

ment securities. As pointed out by the Committee on Co-operation in Madras (1940), "If Central Banks are to advance at the rate suggested by the Reserve Bank, most banks cannot pay their way or meet their working expenses—much less can they afford to pay a moderate dividend to their shareholders, nor can any addition be made to their statutory reserve funds."

Another condition is that the agricultural paper intended to be rediscounted with the bank should be drawn in the form of a single usance bill or usance promissory note drawn by the provincial co-operative bank and the latter should certify by separate documents that the paper is drawn for financing seasonal agricultural operations or the marketing of crops. It has been observed by one writer that as to the co-operative movement its zeal for criticism has hardly been matched by an equally ardent desire to help. Such an advance on strictly orthodox principles is out of date in the present state of the country, which has to make up much leeway before heading towards progress. The same policy of over-caution characterised the relations between the Reserve Bank and land-mortgage banks, when the former refused to buy the debentures of some central land-mortgage banks in spite of their being declared trustee securities, on the plea that they should first interest genuine investors in their debentures. In recent years the Reserve Bank has considerably liberalised its policy and has taken active steps to finance the co-operative banks so as to make agricultural credit elastic.

Agricultural Finance and Reserve Bank of India

The Reserve Bank of India is at present the driving force behind the co-operative movement in India. It has not only liberalised considerably its policy in respect of co-operative credit but has also taken a positive lead in the matter of rehabilitating and revitalizing the machinery of co-operative credit. It will be observed from the preceding paragraphs that at the outset, the Reserve Bank of India had to adopt a conservative policy. But as time passed on, it has now followed a bold policy in setting the co-operative movement on a solid basis. At the instance of the Reserve Bank of India, the Committee of Direction of the

All India Rural Credit Survey was appointed and its report covering the various aspects of agricultural credit constitutes an important landmark in the sphere of agricultural finance. The integrated scheme of rural credit recommended by the Committee, together with its special feature of State-partnership, has not only found ready acceptance but is in process of speedy implementation under the active guidance of the Reserve Bank of India. The formation of the State Bank of India with a view to extending agricultural credit is one of the many steps taken. One of the recommendations of the All India Rural Credit Survey for the orderly financing of the reorganization proposed by it was the creation of five national funds, three in connection with agricultural credit and two for the development of the co-operation and warehousing. Two of these funds *viz.* the National Agricultural Credit (Long-term Operations) Fund and the National Agricultural Credit (Stabilization) Fund, were set up by the Reserve Bank of India in terms of the provisions of sections 45A and 46B of the Reserve Bank of India Act. The Long-term Operations Fund will be used (*i*) for long-term loans and advances to State Governments for a maximum period of 20 years to enable them to subscribe directly or indirectly to the share capital of co-operative institutions, (*ii*) for medium-term loans (between 15 months and 5 years) to State co-operative banks for agricultural purposes, (*iii*) for long-term loans and advances to central land mortgage banks up to a maximum period of 20 years and (*iv*) for the purchase of debentures of central land mortgage banks. The Reserve Bank of India has already credited to the Fund an initial sum of Rs. 10 crores and the Bank's first annual contribution of Rs. 5 crores has also been made to it. The Stabilization Fund will be applied exclusively to medium-term loans and advances to State co-operative banks to enable them to convert their short-term credit into medium-term credit whenever it is necessary as a result of drought, famine or other natural calamities. The Bank has also contributed Rs. 1 crore to this Fund.

In so far as co-operative agricultural credit is concerned, the targets of the Second Five Year Plan are as follows as at the end of the second period of five years in terms of outstanding loans: Rs. 150 crores, short-term (as against Rs. 30 crores existing) ; Rs. 50 crores, medium-term (as against Rs. 10 crores exist-

ing) ; and Rs. 25 crores, long-term (as against less than Rs. 3 crores existing). The number of large-sized primary societies to be established during the Plan period is 10,400. It is further intended that 350 warehouses should be set up by the Central and State Warehousing Corporations. The number of primary marketing societies to be established is 1,800, and the godowns to be constructed by them 1,500. The projected outlay under the Second Plan on co-operative development is about Rs. 47 crores ; in addition, a sum of about Rs. 25 crores required for State partnership in co-operative credit organizations at all levels is to be advanced by the Reserve Bank to State Governments from the National Agricultural Credit (Long-term Operations) Fund. The terms and conditions on which such advances are to be made from this Fund to State Governments were settled by the Bank in the light of the recommendations made at the fifth meeting of the Standing Advisory Committee on Agricultural Credit. That was in February 1956 ; and, during the few remaining months of the year under review, three States (Madras, Orissa and Andhra) were sanctioned loans amounting to Rs. 31.02 lakhs for the purpose.

As indicated above, the outstanding total of all types of co-operative credit is planned to be raised from a total of about Rs. 43 crores to one of Rs. 225 crores by 1960. Much of this expansion, it is hoped, will be effected by the co-operative system through an enlargement of its own deposits and other resources. But there is little doubt that the principal contribution will have to continue to come from the Reserve Bank itself. This contribution will be partly in the shape of loans to State Governments to enlarge the share capital of co-operative banks and societies. Moreover, on the strength of the increased share capital as well as of other relevant factors, such as greater efficiency through the employment of trained personnel, the State Co-operative banks and Central Co-operative banks will, it is expected, render themselves eligible for much larger loans from the Reserve Bank.

Important among the ancillary recommendations calculated to strengthen the structure of rural credit, while at the same time subserving other objectives, are those which have since been embodied in the Agricultural Produce (Development and Warehousing) Corporations Act, 1956, a measure which has only recently been placed on the Statute Book. The Reserve Bank of

India collaborated with the Ministry of Food and Agriculture, at various stages in the preparation of this piece of legislation. Provision has been made for the grant of loans and advances by the Reserve Bank to the Warehousing Corporations established under the Act, through the inclusion of a new Clause (4 C) in Section 17 of the Reserve Bank of India Act.

An important recommendation of the Standing Advisory Committee on Agricultural Credit was to the effect that, in the context of the re-organisation of States, the Agricultural Credit Department of the Reserve Bank should study in advance the problems that would be set to the co-operative institutions, such as apex banks, of the States concerned, and help to solve the technical, financial, administrative and other problems of re-organisation which in due course would confront these institutions. The relevant aspects were accordingly studied in detail by the Agricultural Credit Department and an informal conference of the representatives of the appropriate Governments and institutions was convened in May 1956. The Conference formulated a series of principles of re-organisation on an agreed basis and set up four ad-hoc committees for different regions in order to work out detailed schemes of re-organisation, including division and amalgamation, for the State co-operative banks, central land mortgage banks etc. of the areas affected. The Committees are actively pursuing this work on the lines chalked out at the Conference.

During the year there was an increase in the scale of assistance provided by the Reserve Bank to State co-operative banks to provide medium-term accommodation to State co-operative crops, at the concessional rate of two per cent below the Bank Rate. Thus, 19 State co-operative banks were sanctioned limits aggregating Rs. 29·64 crores in 1955-56, as compared with Rs. 21.21 crores sanctioned to 15 banks in 1954-55. Some of the State co-operative banks such as those in Bihar, Coorg, and Madhya Bharat were granted credit limits for the first time, while certain others were sanctioned higher limits than in the past. Liberalisation of the criteria for fixing credit limits recommended by the Standing Advisory Committee also resulted in sanctioning higher credit limits to some banks, although its full impact on the volume of advances from the Bank will become evident only hereafter. The outstandings of Reserve Bank credit to State co-opera-

tive banks at the end of the year stood at Rs. 12.98 crores as against Rs. 8.11 crores at the end of last year.

It will be recalled that the Reserve Bank of India was enabled to provide medium-term accommodation to State co-operative banks for agricultural purposes under a new sub-section (4A) added to Section 17 of the Reserve Bank of India Act in 1953. According to this Sub-section medium-term loans could be provided up to an aggregate maximum limit of Rs. 5 crores. This restriction has since been removed by a further amendment in 1955 which provides for the grant of medium-term loans out of the National Agricultural Credit (Long-term Operations) Fund. In all, 10 State co-operative banks were sanctioned medium-term loans amounting to Rs. 1.40 crores during the period under review ; nine of these banks were sanctioned medium-term credit limits for the first time. The fifth meeting of the Standing Advisory Committee held in January 1956 recommended that, of the total of the medium-term loans sanctioned by the Reserve Bank of India, not more than one quarter might be for a period of five years, while the balance could be for three years. The Reserve Bank has accepted this recommendation and has given effect to it in the case of medium-term credit limits fixed for the Andhra, Madras and Madhya Pradesh State Co-operative Banks.

The system of inspection of co-operative banks by the Agricultural Credit Department of the Bank on a voluntary basis was continued during the year under review ; 44 co-operative banks were inspected during 1955-56, of which 34 were central banks and 10 were apex banks. With the exception of the Madhya Bharat State Co-operative Bank, the first round of inspection of all apex banks which have been sanctioned credit limits by the Reserve Bank was completed during the current year.

Considerable progress was achieved in implementing the programme for co-operative training drawn up by the Central Committee for Co-operative Training constituted jointly by the Reserve Bank of India and the Government of India. The training of higher co-operative officials of State Governments and of Co-operative institutions was continued at the Co-operative Training College, Poona. About 40 senior officers are trained there every six months. For the intermediate personnel, the full complement of 5 centres has been reached with the commencement of two more

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centres during the year, one at Indore for the Central Zone and the other at Meerut for the Northern Zone, the other three centres being Poona, Madras and Ranchi. These five centres train about 225 co-operative officers of the intermediate level every year. The schemes relating to the training of senior officers and intermediate personnel are financed by the Reserve Bank. Eight training centres were organised for training the co-operative officers required for the National Extension Service Blocks. This was done in pursuance of a decision reached at the second meeting of the Central Committee. All the eight centres are now in session. The cost is met by the Government of India. The scheme for training the subordinate personnel of the Co-operative Departments and co-operative institutions in the various States was put into effect in 18 States ; the cost of this scheme is shared by the Government of India and the State Governments on the recommendation of the Central Committee.

In order to meet the needs of the various States for certain specialised types of trained personnel in the context of programme included in the Second Five Year Plan, the Committee felt that short-term courses in subjects like land mortgage banking, co-operative marketing, industrial co-operation, and warehousing should be organised. Accordingly, ad-hoc courses on co-operative marketing were organised at two of the Regional Training Centres, *viz.*, Poona and Meerut, as an experimental measure. A special course in land mortgage banking commenced at the Madras Regional Training Centre on June 1, 1956 (Source: Report of the Central Board of Directors of the Reserve Bank of India for the year ended 30th June, 1956).

In 1960-61, the Reserve Bank sanctioned loans amounting to Rs. 3.75 crores from the Bank's National Agricultural Credit (Long-term operations) Fund to 12 State Governments to enable them to contribute to the share capital of co-operative credit institutions. Gross disbursements out of the above Fund since its inception on February 3, 1956 to June 30, 1961 totalled Rs. 40 crores ; the total amount transferred by the Bank to the credit of this Fund during the same period was Rs. 50 crores. As of June 30, 1961, the amount to the credit of the Bank's National Agricultural credit (Stabilisation) Fund stood at Rs. 6 crores ; this Fund has not been drawn upon so far.

During 1960-61, 18 State Co-operative Banks were sanctioned aggregate credit limits for Rs. 110 55 crores at the concessional rate of 2% below the Bank rate as compared to Rs. 7.62 crores in 1950-51. In addition one State Co-operative Bank was sanctioned a credit limit of Rs. 1·90 crores at the Bank rate for meeting the working capital requirements of seven co-operative sugar factories. Besides, the Bank has sanctioned medium-term loans aggregating Rs. 4·68 crores out of the National Agricultural Credit (Long-term Operations) Fund for agricultural purposes. The Bank has also subscribed a sum of Rs. 23 lakhs towards debentures floated by Central Land Mortgage Banks with maturity varying from 8 to 20 years. Credit limits aggregating Rs. 50 lakhs were also sanctioned by the Bank to two handloom weavers' co-operative societies for financing bonafide trade or commercial transactions.

During the year 1960-61, 291 co-operative banks, 6 sugar factories and 103 large-sized credit societies were inspected by the Bank. Out of the 1,420 inspections carried out so far, 80 were in respect of State co-operative banks, 1055 of Central co-operative bank, 12 of industrial co-operative banks, 9 of central land-mortgage banks, 9 of sugar factories and 255 of miscellaneous societies (Source: Reports of the Reserve Bank's Central Board of Directors for the year ended the 30th June 1961).

Nidhis and Chit Funds of Madras

The leading idea of Nidhis is mutual credit. Some persons form a company under the Indian Companies Act and attract other members. Funds are raised by monthly subscriptions, which are available for loans to members and repayment with interest by monthly instalments. The objects of the Nidhis are to foster the habit of thrift, stimulate saving, repay past debts, build and repair houses and to give the members the benefit of cheap credit. These are like mutual loan associations but some Nidhis are indistinguishable from joint-stock banks, as they attract deposits as well, as in Coimbatore. The clientele of the Nidhis is usually composed of the officials, traders, merchants, agriculturists Their total working capital was estimated to be Rs. 4 crores in 1929. Loans

are advanced on the security of share-capital, deposits, goods in warehouse, jewellery, immovable property and Government papers. They provide agricultural credit to a great extent.

NATURE OF AGRICULTURAL CREDIT

Agricultural credit may be classified from three points of view, *viz.*, (*a*) the purpose for which credit is intended, (*b*) the length of the period of the loan, (*c*) the security against which loans are granted.

(*a*) *Purpose.*—Agricultural credit is intended for purchasing land, seeds, tools and appliances, and also for effective permanent improvements of land. Credit for permanent improvements of land may be called *Settlement and Development Credit.* Credit required for the purchase of agricultural tools, seeds, fertilisers is called *Production and Equipment Credit.* Credit is also needed for the marketing of produce which may be called *Marketing credit.*

(*b*) *Period of loan.*—Long-term credit is required usually for a period of five to thirty years for the purchase of land and for permanent improvements of land. Naturally the period of repayment is spread over several years by easy instalments. The maximum period for such loans is 36½ years in New Zealand, 50 years in Italy and Japan, 60 years in Denmark and 75 years in France.

Medium-term credit, intended for the purchase of stock and machinery, for small and occasional improvement, for the "production of crops involving a long economic lag", varies from two to five years. In the U.S A. for the supply of intermediate credit, Federal Intermediate Credit Banks were established in 1923 under the Agricultural Credit Act.

Short-term credit is required for transplantation, harvesting, payment of land-revenue, incidental expenses for the maintenance of the family, purchase of manure, seeds etc. and is usually repaid out of the sale of the harvested crops. Such credit is also needed for the marketing of the produce.

(*c*) *According to Security.*—

(*i*) Farm mortgage credit secured against mortgage of land ;

(*ii*) Chattel and collateral credit ; the former being granted on the security of farmer's crops, live-stock, warehouse receipts, and the latter on the security of other properties like shares, bonds, insurance policies etc. ; (*iii*) Personal credit is granted on the promissory notes of the farmers without any security.

Essence of a Good System of Agricultural Credit

1. A good system of agricultural credit should ensure an equalisation of the terms of credit. Credit to agriculture should be available at rates comparable to those paid by other industries. In short, credit should be granted to agriculturists at reasonable terms, for which (*a*) there must be some agencies for the collection of funds and for distributing them amongst the farmers, (*b*) the risk to lenders must be reduced to the minimum, (*c*) the emergence of any monopoly in the capital market, whereby farmers may be exploited, should be prevented. Specialised institutions for agricultural credit can help a great deal in equalising the credit terms, when they are linked up with the Central Bank of the country and develop branch banking. The development of the market for agricultural bills, hundis, warehouse-receipts etc. may also render easy the flow of agricultural credit. Simplification of the legal procedure, reduction of stamp duty and other legal charges etc. may make credit less costly. As Belshaw points out, "The capacity of credit institutions to act as a buffer or to spread risks is one of the important tests of a good system of credit to agriculture."
2. Agricultural credit should be dispensed in a manner suited to the convenience of the farmer. Long-term credit, medium-term credit and short-term credit should be distributed according to the requirements of the farmers. The period of repayment should be determined on an instalment basis having regard to the repaying capacity of the peasants. Credit should be adequate for the purpose it is intended for, and be available without the least

possible delay. The credit system should be elastic, as for example, when crops are moving to the market, credit should be expanded.

3. A good system of credit should safeguard the interests of the farmer. If any property of the farmer is to be sold for the liquidation of his indebtedness, the surplus, that will remain, if any, after adjustment of the indebtedness, should be returned to the farmer.

Effects of Debt Relief Legislation on Credit

Various legislative enactments have been passed in different provincial legislatures to relieve the peasants of the dead-weight burden of indebtedness. The immediate effect of these measures was the severe contraction of credit in rural areas. The village money-lenders felt hesitant to advance credit to the peasants as the repayments were found to be uncertain in case those relief laws were once set in motion. As a result, the peasants were denied the benefit of credit, which was responsible for a serious handicap on their agricultural pursuits. But the Reserve Bank of India is of the opinion that though this has caused some hardship to the cultivator, it has not been an unmixed evil. So far as it could check the propensity of the peasants to approach the money-lenders for borrowings to be used for unproductive purposes, it had a salutary effect in the end. But the difficulty of the peasants in securing credit for pursuing their occupations was aggravated as they had no alternative source of credit. During the time these relief measures were enacted, the co-operative movement of our country was more concerned with re-organisation than with expansion. In the absence of alternative sources of credit, the peasants had to suffer from acute scarcity of credit even for productive purposes. So it was widely held that measures for debt relief and for regulation of money-lenders ought to have been supplemented by an organised development of co-operative societies to grant credit for productive purposes with a view to helping the peasants tide over their difficulties.

Another effect of these measures is a significant decline in the number of unsecured loans. The money-lenders began to insist

on the pledging of tangible securities for the raising of any specific credit, instead of personal security. Besides this, the peasants, who have an inelastic demand for credit, abetted the money-lenders in evading the law. In Madras it has been pointed out that "the small holder or the uneconomic holder now agrees to an inflation of the principal of the loan to compensate for the loss, caused to the creditor by the legal rate of interest. The agriculturist who has excess lands, mortgages them with possession, thereby evading calculation of interest at the legal rate. Payment of interest in kind has been stipulated in certain cases." Thus the creditors and debtors combine together to get over the barriers of law and as a result the very purpose of legal protection of ryots' interests is frustrated.

Another unwelcome feature of such measures is that such relief measures have been adopted piecemeal. Relief has been afforded to debtors not by a single Act but by a series of Acts and as a result a sense of uncertainty has been bred in the minds of the creditors. "What creditors complain of is about the uncertainty of the laws which are sprung on them from year to year. A comprehensive scheme of debt legislation will be less resented by the creditors, as they can adjust themselves to the new situation and carry on the business of money-lending."

Debts have been scaled down no doubt by the Conciliation Board, but there is no machinery which will lend credit to ryots to pay off those scaled down debts. So such relief measures ought to have been supplemented by the scheme of debt clearance in order to be effective. The land-mortgage banks could have helped considerably in this matter, but unfortunately no systematic attempt has been made to develop these institutions. In the absence of organised agencies for debt clearance, the debt relief measures can hardly bear any fruit.

All schemes of debt relief and debt clearance are mere palliatives. These cannot remove the root cause of the poverty of the peasants, unless a comprehensive agricultural policy is chalked out for the improvement of agriculture itself. Debt conciliation can only be a non-recurrent emergency measures These measures possess utility at a certain stage, and thereafter are to be supplemented by such measures, which will aim at preventing the ryot from getting into debt again.

All-India Rural Credit Survey

The All-India Rural Credit Survey was undertaken on the recommendation of an informal conference of co-operators, economists and administrators convened by Shri B. Rama Rau, Governor of the Reserve Bank, in 1951. The conduct of the Survey was entrusted by him to a small committee of Direction of which Shri A. D. Gorwala was the Chairman. The Committee was asked not only to plan, organize and supervise the Survey, but also to interpret its results and make recommendations.

The General Report is divided into ten sections. Section I presents the background of the problem in some detail and lays special emphasis on the socio-economic features which have to be taken into account. Section II briefly analyses the problem and postulates the requirements which have to be satisfied for a solution to be regarded as adequate. In the light of such criteria, Sections III to VI provide a study of the working of each of the existing agencies of rural credit, private and institutional, Sections VII to IX contain the recommendations of the Committee, and, in conclusion, Section X refers briefly to the larger context of both problem and recommendations, namely a total task of national reconstruction which conforms to the directives and aims at the objectives laid down by the Constitution. The basic data relied upon are principally those collected during the survey from 1,27,343 families in 600 villages selected from 75 districts spread over different parts of India ; but other material has also been extensively drawn upon in the formulation of the Committee's recommendations.

Background, Objectives and Requirements

The Report recalls that out of nearly 36 crore people who inhabit India, about 30 crores—or five out of every six—live in the rural area. Some 70 per cent of the total population is either engaged in agriculture or is dependent on those so engaged. About half the national income is derived from agriculture, animal husbandry and allied activities. If the rural population is taken by itself, those who are sustained by agriculture—whether as earners or depen-

dants, and whether as producers, labourers, or others—constitute more than 80 per cent of the total ; and of the remaining 20 per cent, more than two-fifths find their livelihood in rural industries. India, therefore, is essentially rural India, and rural India is virtually the cultivator ; or, if the last term may be enlarged, rural India is virtually the cultivator, the village handicraftsman and the agricultural labourer.

The First Five-Year Plan lays considerable emphasis on increased agricultural production. The emphasis is likely to be even greater in future Plans. This will be rendered necessary by a fast-growing population. On one computation which takes this factor into account, the mere maintenance of the current levels of consumption will necessitate a stepping up of agricultural productivity from 70 million tons in 1951 to 85 million tons in 1961 or an increase of 21 per cent. The dynamic programme of agricultural production that will be needed to achieve such an increase will not be possible without an equally dynamic programme of agricultural credit.

Large holdings, in India, are relatively few and are likely to be fewer as a result of the land policies which Governments have adopted in pursuit of social ends. The medium and small cultivators, who now constitute about 70 per cent of the total, will become increasingly important as the persons whose needs have to be studied and borne in mind in the formulation of policies of agricultural credit and agricultural development. Medium and small holdings now account for about 41 per cent of the agricultural produce of the country ; but, as large holdings give place to that not so large, more and more will the latter be significant even in terms of their share in the total production. At the end of the First Five-Year Plan, the total cropped area will have increased by 100 lakh acres, but only a small part of this additional cropping will be on reclaimed land. With little new land left to be brought under cultivation, the increased production must for the greater part take place on holdings already cultivated ; the modes of increase, in other words, must in the main be in the nature of more intensive utilization of land ; they have to consist, for example, of better seed, more water, more fertilizer, better implements and better techniques of cultivation. All this will mean a considerable outlay in terms of finance and effort. Part of the

cost, as in irrigation, will no doubt be borne by the State, but for the rest, most cultivators will have to be helped with credit to meet the initial and recurring expenditure needed for improvement of land and increase of production. This will be in addition to about Rs. 750 crores which the cultivator, at the present level of his productive operations, may be said to be borrowing every year by way of short, medium and long-term loans.

By and large the cultivator is unable to put by, after each harvest, what he needs till the next for farm business and family maintenance. His normal credit requirements during any year must therefore include both the elements of 'production' and 'consumption'. He also borrows and spends, sometimes unduly, on marriages, funerals and the like. The smaller the holding he cultivates, the more is his dependence on the other forms of earning ; the small cultivator, for example, has often to resort to carting or agricultural labour. For the cultivator generally—whether his farming economy be small or medium or, in relative terms, even large—there is great need of enlargement of the scope of his *subsidiary occupations* ; these may, for instance, be either agro-industrial like the processing of paddy, sugarcane, cotton and groundnut, or of a 'mixed farming' type like dairying and the rearing of livestock in conjunction with the cultivation of land. Finally, of great importance in the economic life of the villager, whether or not he is a cultivator, is the non-farming sector of production represented by cottage industries. A satisfactory scheme of rural credit must cover all these needs. Further considering the problem against the background of the constitutional objectives, the socio-economic background of the Indian village, the pattern of short, medium and long-term requirements of credit, and the security which the bulk of the cultivators can normally offer, the re-organized system of institutional credit should fulfil the following requirements:

(*a*) it should be associated with the policies of the State, especially those which aim at larger rural production ;

(*b*) it should be an effective alternative to—though not necessarily a complete substitute for—the private agencies of credit ;

(*c*) it should have the strength of adequate resources and well-trained personnel, as distinguished from the weakness

which is the present characteristic of co-operative credit whether in finance(administration or supervision ;

(*d*) it should be in a position to co-ordinate its activities not only internally in relation to the different sectors pertaining to short-term, medium-term and long-term credit but also with complementary arrangements for marketing, processing and other economic activities of the cultivator ; also, it should be in a position to co-ordinate its activities with those of the important institutional agencies, including Government, which are engaged in guiding the villager, improving his methods of cultivation, supervising his operations or educating him to avoid wasteful practices ;

(*e*) it should pay special attention to the needs of the medium and small cultivator, and should, therefore, be based on a type of security that, consistently with its adequacy from the point of the creditor, will enable as large a number of solvent producers as possible to use the facilities available through it. In other words, it should lend not merely on the security of land and other more usual forms of a security but also on the security of anticipated crop ;

(*f*) it should disburse credit in a constructive way for the positive benefit of both producer and production ; it should therefore effectively supervise the use of the credit and constantly bear in mind the borrower's legitimate needs and interests ; and

(*g*) it should be such that it helps in the effective growth and development from the village upwards, of the co-operative form of organisation.

With these considerations in mind, the Committee proceeds to examine the record of various credit agencies, private as well as State or State-associated, in order to assess past performance and future significance.

Record of Existing Credit Agencies

The following percentages give an indication of the extent to which the main agencies of rural credit contribute to the total borrowings of the cultivators:

Credit agency	*Proportion in the borrowings (per cent)*
Government	3·3
Co-operatives	3·1
Commercial banks	0.9
Relatives	14·2
Landlords	1·5
Agriculturist money-lenders	24·9
Professional money-lenders	44·8
Traders and commission agents	5·5
Others	1·8
TOTAL ...	100·0

What srtikes the eye at once is the startling insignificance of co-operative credit in this picture. In quantitative terms, it is little more than 3 per cent of the total borrowings of the cultivator. That or worse is the position in many States. Nor is that all. For, what reaches the medium and small cultivator from the co-operative institutions is a mere fraction of the little that co-operatives provide. As a rule, the credit supplied by co-operatives tends to follow ownership of land ; it could be related to produce, if produce were channelled through co-operatives ; but co-operative marketing is itself ineffective and insignificant. Co-operative credit is more developed than co-operative marketing, but, even so, much the larger part of the cultivating population is still outside its ambit. There are large parts of the country which co-operation has not hitherto covered. Even in those areas to which it has extended, there are large sections of the agricultural population which still remain outside its membership ; and even in respect of those who are members of co-operative credit societies, the large bulk of the credit requirements is met from sources other than co-operative. The magnitude of this three-fold inadequacy is such as to warrant from the quantitative, as distinguished from the qualitative aspect only one judgment namely, "failure" on the fifty-year record of the co-operative credit agency in this country. The data of the survey confirm that no other description of the record would be appropriate.

The only other type of institutional credit which is of some significance to the cultivator is that which is supplied by Government—the State Governments and the Central Government—as

taccavi advances, Grow More Food loans, etc. The whole of the agricultural finance derived from Government, however, is again of about the same volume as co-operative credit ; that is to say, it too constitutes about 3 per cent of the total borrowings of the cultivator. But the record of taccavi the Committee observes, is a record of "inadequacies".

(1) inadequacy of amount, inequality of distribution and inappropriateness of security ;
(2) inconvenience of timing, incidental delays and impositions of various kinds on the borrowers ; and
(3) inefficiency of supervision and incompleteness of co-ordination.

Further, Government loans, like co-operative loans are found on investigation to gravitate to the big and large landholder in preference to the medium or small farmer. Neither co-operatives nor Governments have adequate supervisory arrangements to ensure that such small accommodation as they give is utilised for productive purposes.

As direct financiers of the agriculturists, commercial banks are utterly negligible. They supply less than one per cent of the total ; though indirectly, of course, much of the finance provided to traders by these banks percolates ultimately in some form or other to the cultivator. It is interesting to note that these institutions, including the Imperial Bank of India, are largely concentrated in the monetized and commercialized regions of the country. The less developed "subsistence" regions are generally neglected ; in these areas credit is not only difficult to obtain, but is also very costly. Even the co-operative banks and other co-operative institutions are less developed in these areas.

For much the larger part of what he borrows, therefore, *i.e.*, for the balance of about 94 per cent, the cultivator has to depend on private credit agencies. Apart from relatives, these include the money-lender, the trader, the landlord, etc. The money-lender and the trader, between themselves lend more than 70 per cent of what the cultivator today borrows. The money-lender takes no account of purpose, and charges as high a rate of interest as he can. The trader lends on advances for production, but pays as low a price as he can. In the low economy or 'subsistence' areas, *i.e.*, those which grow little else but food for local consumption, the

money-lender's operations assume special significance for the cultivator; the trader makes a more conspicuous appearance in the cash crop or commercialised areas, but here again it is the money-lender that predominates.

Basis of Future Policy

Summing up the position, the Committee observes of agricultural credit, as is supplied by the different agencies, that it falls short of the right quantity, is not of the right type, and, by the criterion of need (not overlooking the criterion of creditworthiness) often fails to go to the right people. This is the picture of today. But what about the future? Rural credit must be directed principally towards improved productivity; it must answer the long, medium as well as short-term needs; it must be supervised; it must be available to all who are creditworthy and at a moderate rate of interest. In Indian conditions, it means reaching down to an enormous number of small farmers, making advances against the credit instruments and securities they can offer, and keeping an effective control over the use to which the credit is put. Obviously, in the village itself no form of credit organization will be suitable except the co-operative society. Private credit, generally unsuitable, is wholly unsuitable in the context of planning for larger production; and institutional credit, which, in broad terms, is the only alternative, tends more than ever to confine itself to the bigger cultivators if it is not channelled through some co-operative form of association within the rural unit of operation. The problem of future policy thus presents itself as a two-fold consideration in the context of credit: Co-operation has failed, but Co-operation must succeed. According to the Committee, the foremost objective of the policy then becomes the positive and deliberate creation of conditions in which co-operative credit will have a reasonable chance of success. This makes it necessary to analyse the main causes of its failure

Reasons for the Failure of Co-operative Credit

Many reasons are usually given but not always in full realisation of the extent and nature of the failure of co-operative

credit in India. Functional, structural and administrative defects, dearth of suitable personnel, lack of training, a background of illiteracy, the grave and chronic deficiency in roads, storage and other vital economic requirements—all these are relevant as part of the explanation. The main casues are much deeper. They are largely socio-economic in character and are related to certain fundamental weaknesses which have developed in the rural structure. Some of the factors making for weakness, such as caste, have always been there ; some of the weaknesses are inherent in most agricultural economies, especially those which consist of small units of operation together covering a vast area ; but the features most significant in this context are those which have emerged from the combined impact of commercial colonialism, industrialization and urbanization on these pre-existing conditions. As a result of all there has been imposed for nearly one hundred years, a powerful, urban and highly monetised economy on a rural structure which had economically been self-sufficient and which socially continued to be based on caste. In its origin, the monetized economy was associated with colonial commerce ; the latter was supported by colonial rule and administration ; with such commerce and administration were associated big financial institutions such as banks and trading houses. In its development, this monetized economy derived strength and support from all these and in particular from the financial institutions which indeed were its accompaniment. The colonial rule underwent transformations ; it became more and more beneficent in its objectives as well as more and more democratic in its character, till finally it gave place to full independence and democracy. However, the financial institutions associated with it or growing under its auspices have in character and functioning remained substantially unaltered. In their effect on the rural economy, in their relations to it and in their attitudes towards its real interests, there has been little change of any significance in the powerful institutions of industry, trade and finance.

Weakness of Rural Economy

The weakness of rural economy may be regarded as of two kinds: (1) internal to the rural structure and (2) external to

it. The internal weakness, in one of its main aspects, is relatable to those conditions in which alone it is possible for optimum wealth to be produced in rural areas. The factors here are social, economic, technological, educational, etc. They pertain to the size of the cultivating unit, the availability of irrigation and other facilities, the existence and scope of subsidiary occupations, the methods of cultivation pursued, the cultivator's attitudes towards production, his habits of thrift or wastefulness and the extent to which guidance is given him or action taken for his benefit in respect of all these. The external aspect is related to the maladjustment between the rural structure and the forces of the urban economy. This maladjustment is strikingly obvious in relation to that part of the urban economy which is expressed in the financial mechanism which is basically urban. The components of this mechanism are many. There are the commercial banks and the whole super-structure of banking, the insurance companies and the investment trusts; the indigenous banker and the money-lender, whose operations, even if only indirectly and at some points, are nevertheless significantly geared to the commercial and central banking mechanism. There is also, in the same sector, the whole organization of urban trade from the big trading firms and the commodity exchanges to the middlemen and the brokers, the private traders and the private markets, the latter both 'regulated' and unregulated. This trading organization is also linked to the commercial and central banking mechanism. By and large, neither the banking system nor the trading organization operates in a way which is in the interests of the rural economy; and together they are much more powerful than any factor or combination of factors that can be internally marshalled from the rural economy itself.

The two aspects mentioned above are interrelated. The internal weakness, partly inherent in any agricultural economy but partly of a type which is characteristic of Indian conditions, prevents the cultivator from making use of the external mechanism of banking or deriving his due share of benefit from that of trading. The external mechanism itself, partly on account of its historical development and inherited attitudes, does not reach down to any except the top layer of the rural economy. It finds that the rural economy is not so organized as to be a good business

proposition for urban financial institutions. Meanwhile, through its very powerfulness it distorts those processes in the rural economy which stand for internal strength and cohesion. This distortion is caused partly by the very existence of a strong force alongside of a weak one and partly by the interpenetration of the former into the area of the latter through money-lenders, traders, etc. This interpenetration takes the form of the existence in the village itself and within the directorates and managements of rural associations and institutions, such as co-operative societies or village panchayats, of a strong element of leadership and influence which, in its interests and attitudes, is attuned not to the other and weaker classes of the rural population, but to the urban forces from which it derives its strength. This element is in the forefront whether the village institution is a body nominated from above or elected from below. It consists of those who have certain types of advantages such as ownership of a big holding or possession or relatively large resources together with the technique of lending them in the form of cash, or a certain degree of education, even if sometimes no more than such minimum knowledge of the language of administration as enables communication with the outside world of financial power and official influence. Any one of these and similar advantages and quite often more than one exist in combination gives the possessor a status in the village and a power for good or evil far out of proportion to the nature of the possession itself. This is almost wholly explained by the access which the possessor thereby obtains to the urban sector in which all the real power and influence and finance reside. Much attention has rightly been drawn by writers, publicists and committees to the Indian villager's social and educational backwardness, to his illiteracy on the one hand and to his caste-riddenness on the other. These are there and these have always been grave disadvantages. But the point is that they have acquired a new dimension of disadvantage in a context in which the enhanced power of a few operates in conjunction with the undiminished loyalties of caste. The total problem thus created is one which, today, the internal strength of the village is powerless to solve. This is so largely because of the totally disproportionate character of the other strength pitched against it: a strength channelled down from the sources of power and finance.

The picture which thus emerges, with the internal and external elements pieced together, is one in which the failure of co-operative credit points especially to that important aspect of the failure which consists in the relative neglect of the credit needs of the medium and the small cultivator and in the reluctance to enlarge membership or take on further responsibilities. At the same time, the utter inadequacy of the total operation becomes for its part explicable in the light of the unequal competition offered by the external mechanism of banking and, linked with it, the often unfair opposition in addition to the wholly unequal competition presented by the external organization of trade. Apart from the competition and opposition are the ingrained, if impersonal, attitudes which characterize the larger part of the urban sector, administrative, financial or banking, in its relations with the rural area and the rural population. Lack of understanding and lack of sympathy, let alone a positive desire to help, are further and potent factors to be taken into account in explanation of the poverty of assistance which the rural institutions of credit have derived from the urban sources of finance.

Rural credit in India, therefore, is part of the larger and living context of India itself. It can neither be understood nor hoped to be solved except as part of such context. As a felt difficulty its locale is the village, but both cause and remedy have to be sought in other places besides the village ; in this sense it ceases to be merely 'rural'. As a felt need its form may be borrowing, but the need itself is an economic one and, therefore, part of a larger economic activity and purpose ; in this sense it ceases to be a merely technical matter of 'credit'. Nor is that all. The context has to be further widened beyond the conventional limits of rural demography and rural economics. For, the activity and purpose which give rise to the need for credit, as well as the manner in which the need itself is satisfied, are conditioned by social background, social structure and social attitudes ; and, though here again the immediate locale of all three is the village, the background is part of the larger socio-economic background of the country and of the historical factors underlying it ; the structure relates itself to the organization of the country's Government and of its more important financial and other institutions ; and the attitudes derive strength or weakness according to the

degree of their attunement to the more important social, economic and political groups who share between themselves all real power in the country. It therefore becomes relevant to take note of the fact that power and importance in India today reside predominantly in the towns and cities and capitals of the country ; so that a search for remedies to the many problems of rural credit must necessarily lead one to reflect on urban institutions, urban groups and urban attitudes as they affect rural well-being.

The first objective of policy should, therefore, consist in undertaking the two-fold task of remedying the internal weakness and rectifying the external maladjustment of the rural structure. In this sense, the problem of rural credit becomes inseparable from that of the reorganization of the socio-economic structure of the Indian village itself ; in other words, paradoxical as it may sound, the problem of rural credit in India is not primarily one of rural credit. Rather, it may be said to be one of rural-minded credit.

In the view of the Committee the prescriptions for the reorganization of co-operative credit hitherto made or tried were in the nature of attempts to counteract the internal weaknesses of the credit structure without taking into account the weaknesses of the rural structure as a whole, much less its maladjustment to the external mechanism of urban trade and finance. Most reforms of the co-operative movement, attempted or effected, have therefore been in the nature of inevitably futile attempts to combine the weak against the strong in conditions in which the weak have had no chance. Thus, effort has been concentrated on thrift, better living, multipurpose, etc., without the prior preparation needed for correcting the maladjustment between the two economies. The arena was cleared for a fight between the weak and the strong with the rules of the game heavily weighted in favour of the strong. The first task is to rectify this position, and enable co-operation properly to function. No criticism of that functioning is likely to be useful or fundamental unless those conditions are first created. Until then, all endeavour at re-organization will imply the expectation that the socio-economic structure internal to the rural sector will itself create those conditions by co-operative combination, good business methods, etc. That, however, is inherently impossible. No amount of small, administrative, functional or other changes

can render co-operation able significantly to help itself. At the most, these changes will effect some small diminution of its very great inability to help itself. The multipurpose idea, for example, whether as at present, or extended in scope into rehabilitation, cannot, except in the context of a larger and more integrated organization, help to bring about the needed results. Any other expectation would imply the assumption that if co-operation has failed in small things, it is only because it has not attempted bigger things. 'Better living' can only come as a later, not earlier, objective. Indian agriculture has often been distinguished from the mode of business which it has in many western countries and, in contrast, been called 'a way of living'. The problem in this respect is to convert it first into 'a way of making a living' and then into 'a way of achieving a better living'. Thus credit must be considered in conjunction with marketing, processing and allied economic activities. All these must go together. Bigger units are necessary. Optimum conditions must be created. These involve (1) finance, (2) flexibility of finance and (3) business technique. Above all, in these and other respects, the strength created must be such as to be effective against the competition and opposition of private trade and other private interests. None of these can be had from the internal resources of the co-operative structure. The choice before Co-operation is, therefore, indefinitely to continue in various degrees to be unable to help itself or to be helped in order that eventually it may not only help itself but need no other outside help.

Essence of the Solution—State Partnership

In the opinion of the Committee, that initial help, if it is to be of the requisite magnitude and of a type which will enable the co-operative organisation to withstand the pressure of opposition of vested interests, can only come from the State. The manner of the help cannot be merely administrative. The State's way of help hitherto has been to over-administer and under-finance. But that is no remedy for a total problem which is one not of rural-minded credit alone but of rural-minded credit in conjunction with rural-minded development of agriculture and rural-minded organization of marketing, processing, etc. The total programme needed

is one of rural re-orientation of the operative forces of the country's administrative and financial organization. It implies a combination of rural conscience, rural will and rural direction. Such a combination strong enough to be an over-riding factor in the situation has to come from Government and the more powerful institutions of Government. In Co-operation, there is at present what may be described as a combination of the weak at the bottom. The State is or ought to be a combination for the weak at the top. An effective programme is possible only if the State at one end joins hands with co-operatives at the other in an effort to bring about the rural-mindedness which is essential to success.

Thus, through one important part of the Committee's recommendations runs the theme, not only of State guidance and State aid, but also of State partnership with Co-operatives in credit, processing, marketing, etc. Since the operations of the banking mechanism as a whole have an important bearing on the first of these aspects, *viz.*, co-operative credit, and the institutional development of storage and warehousing is organically connected with the second, *viz.*, processing, marketing, etc., two other basic considerations which underlie different but connected parts of the Committee's recommendations are the need for positive state association with a defined sector of commercial banking and the need for state initiative and state participation in the creation of suitable institutional means for the promotion of storage and warehousing on an all-India scale. For each of these purposes, the training of proper personnel is necessary. Another, and important aspect of the solution has therefore to be a comprehensive all-India programme for the training of appropriate personnel at all levels.

Integrated Scheme of Rural Credit

The integrated scheme of reorganization of rural credit proposed by the Committee follows directly from this analysis and is based on three fundamental principles of (*a*) State partnership at different levels, (*b*) full co-ordination between credit and other economic activities, and (*c*) administration through fully trained and efficient personnel, responsive to the needs of the rural people. The main features of the scheme are as follows:—

(1) *Credit*

State partnership, including financial partnership, in co-operative rural credit in order that such credit may not only be expanded and strengthened, but expanded and strengthened for the positive purpose of production and for the positive benefit of the rural producer.

(2) *Processing, Marketing, Storage & Warehousing*

State partnership, including financial partnership, for the benefit of the rural producer, in a programme for the organization of processing and marketing on a co-operative basis and for the development of storage and warehousing. The proposals in this connection include the creation of a National Co-operative Development and Warehousing Board, an All-India Warehousing Corporation and several State Warehousing Companies.

(3) *Other Economic Activities*

State partnership, including financial partnership, for the benefit of the rural producer, in a programme for the organization on a co-operative basis of such of the other economic activities of the village as are of importance to him as cultivator, agricultural labourer or handicraftsman, such activities to include farming, irrigation, provision of seed and manure, transport, fisheries, dairying, livestock-breeding and cottage industries.

(4) *Commercial Banking*

Integration of, and the State's financial participation in, an important sector of commercial banking in order that the State-partnered, country-wide banking institution so formed may, among other things, be charged with and carry out the positive duty of endeavouring to do its best to help the development of rural and co-operative banking. It will be expected to discharge this duty by the several means open to it including, principally, the effecting of arrangements for the readier and cheaper remittance of money, especially in relation to the relatively undeveloped areas which have been neglected by commercial banks and in which, without such facilities, no development of rural or co-operative banking is possible. (It has been proposed that the institution thus created should be called the State Bank of India.)

(5) *Training*

Recognition of the importance of training a new type of personnel altogether, which is not only technically qualified, but is also in its sympathies and attitudes rurally biassed in order that the new functions devolving on the State by reason of the above may be discharged both efficiently and for the benefit of the rural population.

(6) *Limitations on State-partnership and State intervention*

Recognition of the need so to design the extent and manner of State partnership as to ensure that, while responsiveness to the new policies is effectively created, every precaution is taken to safeguard the essential character of the institution in which such participation takes place and nothing is done such as may lead to State interference in its day-to-day working; recognition, further, so far as co-operative credit and co-operative economic activity are concerned, of the need so to regulate the extent of State partnership at different levels as (*a*) at the rural base to leave scope for the societies to become fully "co-operative", within a measurable period, by the process of themselves replacing the State part of the share capital and (*b*) at the higher levels to retain what may be described as the major partnership of the State until such time, however long, as may be required in the interests of the co-operative organization at the rural base which, before it develops sufficient strength, and for the purpose of developing such strength, will need, against the competition and opposition of private vested interests, and for various other reasons, a support which is at once powerful, sympathetic, financially adequate and technically competent.

(7) *Finance and Funds*

The Committee has proposed the institution of certain funds for the orderly financing of the reorganization proposed. These are—

(*i*) Under the Reserve Bank:

(*a*) The National Agricultural Credit (Long-term Operations) Fund [Rs 5 crores annually besides an initial non-recurring contribution of Rs. 5 crores].

(*b*) The National Agricultural Credit (Stabilization) Fund [Rs. 1 crore annually].

(*ii*) Under the Ministry of Food & Agriculture:
The National Agricultural Credit (Relief and Guarantee) Fund [Rs. 1 crore annually].

(*iii*) Under the National Co-operative Development and Warehousing Board:
(*a*) The National Co-operative Development Fund.
(*b*) The National Warehousing Development Fund. [Rs. 5 crores annually to be divided between (*a*) and (*b*), besides initial non-recurring contribution of Rs. 5 crores to (*b*)].

(*iv*) Under the State Bank of India:
The integration and Development Fund.

(*v*) Under each State Government:
(*a*) The State Agricultural Credit (Relief and Guarantee) Fund.
(*b*) The State Co-operative Development Fund.

(*vi*) Under each State Co-operative Bank, Central Co-operative Bank, etc.:
The Agricultural Credit (Stabilization) Fund.

Of these funds, the five national funds are of special importance. It has been proposed that the allotments for these may be reviewed after a period of five years.

I—Recommendations in Detail

The principal recommendations of the Committee are summarized below under the various heads of development and the agencies to be charged with their implementation.

Development of Co-operative Credit

(1) *Reserve Bank*

(*i*) The Reserve Bank of India should collaborate with the State Governments in drawing up plans for the co-ordination and reorganization of co-operative credit institutions on the lines recommended. For this purpose, the Reserve Bank should be

statutorily empowered to make long-term loans to State Governments. It should make these loans, as and when necessary and on suitable terms, in order that the State Governments may, directly or indirectly, participate in the share capital of State co-operative banks, central co-operative banks, larger-sized primary credit societies, central land mortgage banks, primary land mortgage banks, etc. The loans may be made from the National Agricultural Credit (Long-term Operations) Fund.

(*ii*) The Reserve Bank should continue to give short-term accommodation on the guarantee of the State Government, through State co-operative banks. It should also give medium-term loans (of periods ranging from 15 months to 5 years) to State co-operative banks and through them to central co-operative banks or societies. The present overall limit of Rs. 5 crores should be removed as well as the restriction relatable to the owned funds of State co-operative banks ; the limit should be set by the Reserve Bank's overall appreciation of the financial position of the State co-operative bank, central co-operative bank, etc., to which it lends.

(*iii*) The Reserve Bank should be enabled to give long-term accommodation (*i.e.* accommodation for periods exceeding 5 years) to land mortgage banks (*a*) by way of direct loans and (*b*) by purchase of the whole or part of 'special development debentures' of the land mortgage banks. It may do so by drawing upon the National Agricultural Credit (Long-term Operations) Fund. This type of operation, however, will be distinct from that of the normal purchase of 'marketable' debentures as part of the Bank's ordinary operations and in pursuance of its existing policies. In all these cases, both principal and interest should be guaranteed by the State Government.

(*iv*) The National Agricultural Credit (Stabilization) Fund is to be utilized for the purpose of granting medium-term loans to State co-operative banks, etc., in circumstances in which the Reserve Bank is satisfied that any of its short-term loans to them of which repayment has become due cannot, without serious dislocation to the co-operative credit structure of the State, be repaid in time on account of famine, drought, etc., and consequently that repayment of such loans, or part thereof, may justifiably be allowed to be deferred. In such a case, a book adjustment will be made between the Stabilization Fund and the Banking Department of

the Reserve Bank ; the short-term loan will be technically treated as repaid but in effect converted into a medium-term loan from the Reserve Bank's Stabilization Fund. The Reserve Bank may make this facility conditional on the State co-operative bank concerned maintaining a similar Agricultural Credit Stabilization Fund ; the same condition may be made applicable to central co-operative banks and, where feasible, to the larger-sized primary societies ; the Reserve Bank may further insist that part of the overdue liability should be met from the Stabilization Funds kept within the co-operative credit structure itself.

(*v*) The operation of these Funds, and the planning and execution (within the Reserve Bank's own sphere) of the programmes and policies for which they are intended to be utilized, should remain the responsibility of the Reserve Bank and its Board, in their normal functioning, and should not be vested in a separate body, statutory or other. The Agricultural Credit Department of the Reserve Bank should be reorganized and strengthened for the purpose of discharging adequately the additional responsibilities placed on the Bank in this context. The Standing Advisory Committee of the Reserve Bank should be continued, though as a smaller expert body. At the same time, there should be an Advisory Council which is representative of the appropriate interests on a nation-wide basis. This Council should be common to the Reserve Bank and the Ministry of Food and Agriculture, including the National Co-operative Development and Warehousing Board.

(2) *Central Government*

The Ministry of Food and Agriculture should utilize the National Agricultural Credit (Relief and Guarantee) Fund in order to give grants, by way of relief, to co-operative credit institutions, through the State Governments concerned, for the purpose of writing off irrecoverable arrear, where these have assumed a magnitude which threatens the stability of the structure and provided that the Ministry is satisfied that such arrears have arisen from causes, such as widespread or chronic famine, beyond the control of the co-operative institutions concerned. Relief from this Fund may be conditional on the State Government making a stipulated contribution, for the same purpose, from

a corresponding Agricultural Credit (Relief and Guarantee) Fund maintained by it.

(3) *State Governments*

(i) The State Governments will be responsible for the implementation of planned programmes of credit development which will be drawn up in consultation with the Reserve Bank.

(ii) Taccavi and similar agricultural loans from State Governments, and Central Government funds, if any, channelled through State Governments, should (subject to the following exceptions) be strictly limited to 'distress' finance, to meet contingencies such as famine, scarcity, etc. The exceptions are as follows:

(a) Where co-operative credit institutions are yet to be developed and purely as a transitional arrangement, taccavi may continue to be given for productive purposes. But in all such cases co-operative institutions should be sought to be promoted as early as possible.

(b) Special credit arrangements may be made for certain areas or for certain classes of people. The former would include areas which are markedly undeveloped in the economic aspect (*e.g.*, areas inhabited by backward tribes). The latter would comprise economically backward occupational classes for whose benefit special policies of rehabilitation are adopted.

(4) *The Co-operative Movement*

(i) *Structure and Personnel*:

(a) A phased programme for the reorganization of co-operative credit institutions at all levels should be drawn up by the State Government in consultation with the Reserve Bank.

(b) The reorganization should be on the basis of major State partnership. Such State partnership should continue to be 'major' for an indefinite period at the apex and district levels. It will be so for a more limited period at the primary level. State participation will be direct at the apex level and indirect at the district and primary levels, *i.e.*, through the State Co-operative Bank in the case of central banks,

and through the state and central co-operative banks in the case of larger-sized primary credit societies.

(*c*) Trained personnel for the key posts of credit institutions at the higher levels, and where feasible also of the larger-sized primary societies, should be 'deputed' to these institutions, wherever that is necessary and suitable, from cadres instituted either by the State Co-operative Bank (if sufficiently strong and developed) or by the State Government. (For marketing, etc., as distinguished from credit, this function of providing technical personnel will necessarily devolve on State Governments and not on State Co-operative Banks.) The State Government's Co-operative Service may, in suitable cases, be reorganized in two broad divisions: (*a*) administrative and (*b*) technical. There would thus be a State Co-operative Administrative Service (Class I and Class II) and a Subordinate Co-operative Service (Administrative; as also a State Co-operative Technical Service) (Class I and Class II) and a Subordinate Co-operative Service (Technical).

(*d*) There should be co-ordination of the maximum possible extent between the short-term and long-term parts of the credit structure. While remaining legally and financially distinct from each other, State Co-operative Banks and central land mortgage banks should have a common administrative staff and, if possible, a common board of directors; where the latter is not feasible, there should at least be some directors common to the two boards.

(*e*) One of the main lines of future development of the primary credit structure should be in the direction of organizing larger-sized societies with limited liability.

(*f*) Complementary to the recommended establishment of a National Agricultural Credit (Stabilization) Fund in the Reserve Bank individual Agricultural Credit Stabilization Funds should be instituted by State Co-operative Banks and central co-operative banks and,

wherever possible, also by larger-sized primary credit societies.

(ii) *Operations and Supervision :*

(a) The basis for short-term credit should be the system of 'crop loans'—a system which concentrates on loans for productive purposes ; provides short-term loans on the basis that a crop is anticipated, not that a title exists ; relates such loans in amount to the estimated outlay on raising the crop ; and, as and when the crop is sold, recovers the loans from the proceeds of the sale. It is proposed that the loans, should, to the maximum extent possible, be disbursed in kind.

(b) The subsistence needs of the agricultural producer—as distinguished from specific 'consumption' needs—should be met, as part of normal agricultural credit requirements, by the primary credit society. For credit needs connected with specific items of consumption (such as marriages and illnesses), a 'chit-fund' may be incorporated within the framework of the larger-sized primary credit society. The membership of the chit fund may be wider than that of the society and may include, not only the cultivators, but also the agricultural labourers, and the handicraftsmen and artisans of the village.

(c) Medium-term loans (fifteen months to five years) should be provided by the short-term structure of co-operative credit ; in this context, special attention should be paid to loans for the purchase of livestock. The making of long-term loans should be the responsibility of land mortgage banks ; these should be established (or reorganized) in different States.

(d) At the district level, the central bank or the branch of the apex bank should have a 'section' for dealing with long-term credit on an agency basis. This 'section' may be converted into a branch of the central land mortgage bank in course of time. Eventually, primary land mortgage banks should be formed.

(*e*) Loans of land mortgage banks should be primarily for productive purposes. Different types of aid and accommodation from Government and the Reserve Bank are envisaged. The flotation of 'rural debentures' is among the various changes recommended in system and procedure.

(*f*) Supervision of societies should be a function of the apex and central banks ; audit, along with general administration, should continue to be the responsibility of the State Government.

II—Development of (1) Co-operative Economic Activity Especially Marketing and Processing and (2) Storage, Warehousing and Distribution

(1) *Co-operative Economic Activity, Especially Marketing and Processing*

(*i*) The National Co-operative Development and Warehousing Board should, from its National Co-operative Development Fund, make long-term loans, on suitable terms, to State Governments to enable the latter to participate in the share capital of co-operative societies when undertaking such activities as processing, marketing, dairying, etc.

(*ii*) *The State Governments*

The responsibility for strengthening the administration, for providing the necessary technical services and generally for implementing a planned programme in respect of the development of co-operative processing, co-operative marketing, etc., will of course primarily vest in the State Government.

(*iii*) *The Co-operative Movement*

(*a*) Co-operative societies for marketing, processing, dairying, etc., may be organized in conformity with a plan drawn up by the State Governments in conjunction with the National Co-operative Development and Warehousing Board. The organization of the

societies should be on the basis of major State-partnership. Trained technical personnel for these purposes should be provided by the State Governments.

(*b*) Extension and development of co-operative marketing societies at the primary level and at the other levels to the extent necessary to support the primary structure, is envisaged. The programme should be vigorously pursued; but, to start with, societies should be organized at selected places after adequate preliminary consideration and preparation, with a view to complete success being assured at the important initial stage of development. This also applies to societies for processing and other important economic activities.

(*c*) It is necessary to ensure by positive State supervision, that every marketing society at the primary level is so composed and organized and its affairs so conducted that the medium cultivator certainly, and the smaller cultivator wherever possible is effectively represented in the organization and his interests adequately looked after by those in charge of it.

(*d*) Wherever a regulated market exists in the area of operations of a primary marketing society, the local marketing society (as also the local co-operative banking organization, if any), should have the right to nominate one or two of its members on the Market Committee; where the regulated market happens to be managed by the All-India Warehousing Corporation or the State Warehousing Company, this right would be exercised in relation to the Advisory Committee formed to assist the officer of the Company or the Corporation.

(*e*) In regard to marketing societies (also processing and similar societies), there should be compulsory additional contribution to share capital, the amount of contribution being related to the turnover of a member's sales through that society or to the size of the loan taken by the member (from, for

example, a credit society with which the operations of the marketing or processing society are co-ordinated).

(*f*) As a rule, there should be no compulsory acquisition of processing plants for the purpose of entrusting them to co-operatives but, where members of a co-operative society or persons prepared to form themselves into a co-operative society offer to subscribe not less than 30 per cent of the share capital, the State Government may, after notification, compulsorily acquire the concern for this purpose.

(*g*) State Governments should take steps for licensing all plants, factories and mills (other than at the cottage industry level) engaged in the processing of agricultural commodities or in related activities and meanwhile promote, as soon as possible, such legislation as may be necessary for the purpose. Before issuing a new licence in any particular area Government should ascertain whether any existing co-operative society, or one likely to be formed, is both willing and in a position to take up the work. In that event, the licence should be issued to the society and not to the private party.

(2) *Storage, Warehousing and Distribution*

(*i*) The National Co-operative Development and Warehousing Board should be in charge of two distinct, but organizationally inter-related, lines of development concerned with storage and warehousing on the one hand, and distribution on the other, the distribution pertaining to the basic requirements of the cultivator (*a*) as producer and (*b*) as consumer. It should plan and finance such activities by granting loans, subsidies, etc., drawing for this purpose on the National Warehousing Development Fund. Another use for this Fund will be to enable the Board to subscribe to the share capital of the All-India Warehousing Corporation besides enabling the latter, as well as State Governments, in their turn, to subscribe to the share capital of State Warehousing Companies. Lastly, the State Warehousing Companies can themselves contribute to the share capital of

co-operative marketing societies, etc., which take up the provision of storage or warehousing as one of their primary functions.

(*ii*) The All-India Warehousing Corporation should be in charge of the development of storage and warehousing at centres of all-India importance.

(*iii*) The State Warehousing Companies, formed by joint contribution to the share capital by the All-India Warehousing Corporation and the State Governments concerned, should be in charge of the development of storage and warehousing at centres of importance at the State or district levels.

(*iv*) The management of the regulated markets, if any, at centres to which the All-India Warehousing Corporation or the State Warehousing Company has extended its operations should be statutorily entrusted to that institution. A local Advisory Committee may be appointed to assist the officer of the institution at such places.

(*v*) The co-operative organization will be concerned with the development of storage and warehousing in the interior of the district, *e.g.*, in smaller towns, especially if such towns happen to be marketing centres. The picture will be complete if societies in the bigger villages will also each build their own godowns, seed stores and so on, in exercise of their multi-purpose functions.

(*vi*) At all the levels mentioned above, godowns and warehouses may also be used for the purpose of distribution of commodities such as fertilizers, etc., as also articles of basic use to the cultivators such as sugar, kerosene and matches. Such distribution should be done on an "agency" basis, *i.e.*, without trading risk to the Corporation, Company or Society.

(*vii*) There will ordinarily be no compulsory acquisition of godowns and warehouses for the purpose of entrusting them to the All-India Warehousing Corporation or a State Warehousing Company or a co-operative society; where, however, a godown or a warehouse is situated at a regulated market or other place notified in this context, the acquisition may be compulsory, but on payment of compensation, etc.

III—Development of Rural and Co-operative Banking Facilities

These facilities will be provided principally by the State Bank of India. The object of the Committee is the creation of one strong, integrated, State-sponsored, State-partnered commercial banking institution with an effective machinery of branches spread over the whole country, which, by further expansion can be put in a position to take over cash work from non-banking treasuries and sub-treasuries, provide vastly extended remittance facilities for co-operative and other banks, thus stimulating the further establishment of such banks, and, generally, follow a policy of advances including advances for agricultural purposes—which, while not deviating from the canons of sound business, will be in effective consonance with national policies as expressed through the Central Government and the Reserve Bank.

(*i*) The State Bank of India should be formed by the statutory amalgamation of the Imperial Bank of India and the other State-associated banks, namely, the State of Saurashtra, the Bank of Patiala, the Bank of Bikaner, the Bank of Jaipur, the Bank of Rajasthan, the Bank of Indore, the Bank of Baroda, the Bank of Mysore, the Hyderabad State Bank, and the Tranvancore Bank (together with a few minor banks) ; the share capital of the new institution should be expanded, and the additional shares allotted (on the basis of non-transferability and restricted dividend) to the Government of India and the Reserve Bank ; in addition, the Government of India should also take over certain shares now held by State Governments ; together, the Central Government and the Reserve Bank should hold a majority of votes in the State Bank. The Committee has suggested that the composition of the share capital of the new institution should be such that the Government of India and the Reserve Bank will together hold 52% of the share capital and of the votes.

(*ii*) A majority of the Directors of the Central Board of the State Bank should be nominated by the Central Government and the Reserve Bank. The Chairman should be appointed by Government after consultation with the Board. The appointment

or removal of the Managing Director and the Deputy Managing Director should be subject to the approval of Government.

(iii) There should be six Local Committees, one each for six suitable areas into which the jurisdiction of the Bank should be divided. The Chairman and a majority of members of the Local Committees should be nominated by the Central Board.

(iv) The State Bank of India should pursue a large and expeditious programme of branch extension to and beyond the district headquarter places.

(v) The dividend on the shares held by Government and the Reserve Bank which should not exceed 5%, should be credited to an 'Integration and Development Fund' to be established within the State Bank itself. The losses, if any, beyond the agreed level, on the opening of new branches should be met out of this fund, as also certain expenses consequent on the establishment of the Bank. It has been suggested that an initial contribution of Rs. 50 lakhs and subsequent ad hoc contributions (as and when necessary) should also be made to the Fund by Government and the Reserve Bank.

(vi) It will be expected of the State Bank of India to be responsive to the needs of co-operative institutions connected with credit, marketing and processing. The branch expansion of the State Bank of India should be co-ordinated and, wherever possible, positively associated with the development of co-operative credit. Particular attention to this aspect should be given at the 'sub-divisional' level.

IV—Development of Facilities for the Training of Personnel

(i) The Central Committee for Co-operative Training, which is already taking steps to organize co-operative training on a countrywide basis (a) by establishing regional centres for intermediate personnel (besides the All-India Centre at Poona for higher and intermediate personnel) and (b) by improving the training facilities for subordinate personnel in collaboration with State Governments, should (to the extent required) be placed in possession of larger funds by the Government of India and the

Reserve Bank in order that it may further enlarge the scope and expand the coverage of its training facilities.

(*ii*) The training facilities should cover all levels of training, and all personnel whether departmental or institutional. In particular, attention should be paid to banking, marketing and industrial co-operatives, as also to administration, supervision and audit.

(*iii*) The training facilities should be co-ordinated with the needs of the personnel of community projects and extension blocs.

(*iv*) In organizing such training, the Central Committee should take full account of the need to train a new type of official who will be responsive to rural needs, besides possessing the necessary background of training.

Miscellaneous Suggestions and Observations

(1) *Role of Private Agencies*

As the whole object of the Committee's scheme is to attempt to develop and strengthen a State-partnered co-operative banking structure so as to provide an effective institutional alternative, and therefore, a rival to the money-lender, and thereby direct his energies and resources to activities more useful from the point of view of the cultivator, the Committee has not assigned any place to the private money-lender in the scheme. A hope is, however, expressed that the private money-lender as well as the trader, indigenous banker and the commercial banks (other than State Bank of India) will, in their individual degrees, supplement the integrated scheme of rural credit, though not finding place in the scheme itself. The commercial banks, in particular, will be enabled, through the provision of a wide network of godowns and warehouses, to make credit available for agriculture on a much larger scale than hitherto.

(2) *Rural Savings*

The Committee has observed that the proportion of rural families who were in surplus and had, therefore, financial investment to report was significantly low ; so also was the size of the investment During the survey years, investment in the form of shares, deposits, etc. from owned resources amounted, on an

average, to less than Rs. 4/- per family, barring 2 regions, where it ranged around Rs. 10/- per family. It was noticed that a substantial proportion of the total expenditure on such items of financial investment (which need not be regarded as being required for meeting current capital or other needs, whether of production or consumption) was, as a rule, accounted for by the topmost cultivators. For these big cultivators, the relevant proportion ranged from 40% to 90% in most regions, whereas the medium cultivators accounted for less than 20% and the small cultivators for hardly 5%. The position was similar in regard to funds estimated to have been invested by rural families in lendings. On the other hand, many cultivators had unfulfilled credit needs of various degrees in connection with expenditure on farm development. These requirements amounted to about Rs. 1,300 per family for the top 50% of the cultivators and about Rs. 800 per family for the other half. Among the more important purposes for which the unavailable credit was stated to be required were increase of the size of holding, digging of wells and purchase of bullocks. From the data available to it, the Committee has concluded that—

(*a*) the need to make rural savings possible is much more important than to render rural savings available ;
(*b*) to the extent they exist, rural savings are most likely to be rendered available where most seem to be used for rural needs ; and
(*c*) rural savings fall so short of rural needs, that they must be supplemented from, not diverted to, urban areas.

The Committee has suggested that Government loans should be designed to mobilize savings from urban and semi-urban areas rather than from rural areas. These latter should be left to be drawn upon by the land mortgage banks and co-operative societies. According to the Committee, there are four specific ways in which the Primary Credit Societies, the Central Banks, the Central Land Mortgage Banks and the marketing, processing and other societies should be able to mobilize rural savings on a much larger scale than hitherto, *viz.*, by the promotion of chit funds, retirement of Government capital in co-operative banks, etc., development of co-operative marketing, processing and other forms of economic activity and by issue of co-operative debentures of land mortgage

banks. The Committee recommends that rural debentures issued by land mortgage banks should, as far as possible, be for specific projects of development in which the villager is interested in different degrees, and should be issued at the time of harvest and sale of crop. In regard to the period of repayment, these debentures should be so designed as to suit the requirements of the rural investor. The Committee considers that any extension of the experiment of mobile banks should be restricted to areas which present no near prospect of development in the sphere of co-operative credit. A mobile bank in any area should be allowed to function only on the condition that the commercial bank concerned undertakes to advance, for agriculture and allied purposes, amounts not less than the deposits it collects from that area.

(3) *Debt and Tenancy Legislation*

The Committee accepts the social desirability of the different types of legislation of importance to rural credit, *viz.*, debt relief, money-lending, tenure and tenancy, but it considers that the curtailment of private credit, whether from the money-lenders or the landlords, is implicit in these measures. Complementary to the desirability, therefore, is the need that is seldom recognized: the need for large-scale development of institutional credit, co-operative or State-sponsored. Social change of the kind that is being legislated for will not come and hitherto has not come—without corresponding dislocation in the particular sectors of reform as its accompaniment. Even as it is desirable to provide for the change, so also is it necessary to provide against the dislocation. Again, between the need to make the cultivators' rights in land inalienable for reasons of social policy and the need to make them alienable so as to facilitate the obtaining of credit, specially long-term credit, a certain degree of conflict is inherent in the developments. Here also, therefore, social desirability is accompanied by complementary needs, one of which is the need for a change in the present emphasis which institutional credit of all types—short-term, medium-term and long-term—lays on ownership. In regard to some of these types, for example, there might have to be a shift of emphasis from ownership to productive capacity—from land to produce from land—as the basis of credit, and from dependence on eventual sale of land to dependence

on effective supervision of operations as the basis of recovery of credit.

In regard to the control of the activities of the money-lender, while the Committee generally supports the recommendations of the Agricultural Finance Sub-Committee, it considers that the rates of interest prescribed in the different States should be reviewed and revised in a realistic manner. It also recommends a review of the arrangements for the enforcement of the money-lending legislation by provision of adequate supervisory staff, preferably under the Registrar of Co-operative Societies.

(4) *Stabilization of Agricultural Prices*

One of the assumptions made by the Committee and one which underlies its recommendations is that Government's price policies will be such as to ensure that stability of agricultural earnings and therefore the stability of agricultural credit. It is pointed out that, if the need for price support should arise, there will have been established, in pursuance of one set of its recommendations, an important instrument of policy in the form of a widespread network of godowns and warehouses (together with an organized structure of co-operative processing and marketing) at various points in the country, strategic for the purchase and storage of foodgrains. This machinery will also be of great importance in the reverse contingency of a policy of price control. To the extent that Government decides to seek to influence agricultural prices in either direction by itself entering the market on a large scale, the first and most important step in the operation is the purchase of the produce of the cultivator. If the context is price support, the purchase is at a guaranteed minimum price ; if it is price control, the purchase is at a prescribed maximum price. In either case, obviously, there has to be an adequate administrative machinery ; but there will also be needed the sheer physical accommodation for storage of grain all over the country. The warehousing organization proposed, designed as it is to develop such accommodation as also to co-ordinate it between the all-India, State and village levels, will have in its possession the physical storage ; further, it will make available an extensive body of trained personnel for custody of the produce and for its grading and valuation.

(5) *Forward Markets*

The Committee recommends that an adequate enquiry should be conducted for ascertaining—

(*i*) the extent to which damage, if any, is caused by these institutions to the interests of the rural producer ; and, if the damage is appreciable, what measures are needed to prevent it ; and

(*ii*) whether these institutions can be so reorganized and controlled as not only not to do harm to the cultivator (if that is the present position) but to be of positive benefit to him, in the context, specially of his economic activities being organized under State partnership in the manner recommended by the Committee.

(6) *Famine Funds*

Since credit forms part of the much larger problem that presents itself in the context of widespread rural distress and economic dislocation caused by famine, flood, etc., the Committee suggests an investigation into the need (*i*) for increasing the State Famine Funds, (*ii*) instituting such funds in States which have not hitherto established them and above all (*iii*) for the institution of an adequate Central Famine Fund in order that individual States may be helped by loans etc., to tide over the difficulties created by any acute or recurring conditions of famine or scarcity, or some grave disaster such as a severe and extensive flood.

(7) *Village Roads*

Deplorably absent as a rule, and deplorably bad if and when present, these communications, absent and present alike, are most deplorable when considered as the hiatus which they in fact represent between field and market. The Committee suggests the allocation of much larger funds and diversion of a large effort to the improvement of village roads, and, in particular, the allotment of a high priority to those communications which connect the villages to their marketing centres. A review is also suggested of the transport conditions—rail, bus, steamer, etc.,—and of the charges now made by the transport agencies from the point of view of the rural producer.

(8) *Finance for Rural Industries*

While recognizing that there are certain difficulties which are special to cottage industries, as distinguished from agriculture, the Committee hazards the opinion that the problem of organizing such industries on co-operative lines—a suggestion generally made —will have in many respects a parallel in the problem of organizing agricultural credit and agricultural economic activities on co-operative basis. It, therefore, takes the view that Central and State Governments and such bodies as the all-India Handloom Board, All-India Khadi and Village Industries Board might think in terms of active partnership in finance and State participation in organization of these industries, as distinguished from a programme confined to loans, subsidies and similar ad hoc assistance. While expressing itself against the setting up of separate industrial co-operative credit banks to finance such industries, the Committee makes the suggestion that the State Financial Corporations and the Reserve Bank should play a more active role in the matter of financing co-operatively organized rural industries, the former by making long-term and medium-term loans available and the latter by augmenting the short-term resources of the co-operative credit structure. The desirability of re-investigating rural industrial credit, with other aspects connected with these industries on the lines adopted by the Committee for agricultural credit, is also suggested.

(9) *Administrative Reforms*

Considering the problem of administrative reform in the extended light of the analysis and proposals made by it, the Committee points out how the programmes of development can be thwarted by the deficiencies and unresponsiveness of the administrative set-up, and observes that there is first of all the need for Government to make its administrative role in the village more and more that of a beneficent authority and less and less that of the tax-gatherer which it has been till recently. In this connection, the Committee regards the National Extension Service as one of the most significant administrative developments of recent years. Secondly, again in the village, there is the need for Government to assume the function of real partnership in economic development—especially of the middle and lower groups—and not merely

that of administration on the one hand or of advice and extension on the other. Thirdly, there is the need not only to simplify development administration at the village end, as in National Extension Service, but also to achieve effective co-ordination between (*i*) the different administrative agencies of development, including that of Local Self-Government and (*ii*) those agencies and the machinery of basic administration. A large field remains to be explored in connection with the more effective association of the local bodies of administration—panchayats, local boards, etc., —with local projects of planned development, *e.g.*, those relating to minor irrigation, no less than roads, public health or primary education. As for the other and much needed co-ordination between the agencies of development and of basic administration, the proper line of re-organization would seem to be that the Collector himself should become the Chief Development Officer of the District and so too, in their respective jurisdictions, the sub-divisional revenue officials ; whereas lower down, the subordinate revenue officials should have a more restricted and specialised role than at present, the "general" functions they now exercise being passed on progressively to the appropriate developmental staff. There will then be a transformation of the old order, rather than the introduction into it of miscellaneous and inchoate sub-strata as at present, or the replacement of it altogether by a wholly untried new order. At a higher level, in the Secretariates of State Governments, a tentative line of reorganization, which suggests itself to the Committee (for the bigger States at any rate) is that the Chief Secretary should be assisted by two additional Secretaries (or other top-ranking Secretariate officials), one in charge of basic administration in its more general aspects (such as organization and methods) and the other in charge of all items of development which are of importance to the rural area or intimately connected with those items, the main subjects thus co-ordinated at the very highest level in the Secretariate being (1) Agriculture, (2) Co-operation, (3) Cottage Industries and (4) Industries. The main requirements are that, for purposes of formulation and administration of policy at the State Secretariate level, co-operation should be treated as organic part of "rural development" in all its main aspects ; that administration of that development as a whole should be intimately co-ordinated with basic administration ; and that the

two together should be placed at the highest point of responsibility and co-ordination in the Secretariate.

Larger Context

The Committee discusses some of the more important directives of the constitution, and observes that the object of any plan which subserves these objectives must work for the weaker sections of the population. Thus the medium and small cultivator, the agricultural labourer, the smaller operator in industry and transport and the lower middle classes and the backward classes and tribes have a prior claim on the attention of a democratic and planning State: they are numerically large, economically important and socially disadvantaged. In the case of most of these mere legislative, administrative and educational efforts will not solve the problem of their welfare ; for the diminution and eventual removal of these disadvantages, concerted, nation-wide, State-sponsored and, to the extent necessary State-financed measures are called for. The Committee claims that of a plan which embodies such measures, the proposals made by it in the somewhat restricted context, largely of the medium and small cultivator and partly and incidentally of the handicraftsman, rural and urban, constitute a logical, necessary and integral part. Again, India has set before itself the ideal of a Co-operative Commonwealth. There can, however, be no commonwealth without wealth for the common man. The common man of India today, as well as of tomorrow and of the day after, belongs to rural India. Predominantly he resides in rural India. Even where a lopsided economy has in appreciable number drawn him to the big cities and enlisted him in the ranks of industrial labour, his heart and his interests continue to be in rural India. The only plan that can restore vitality to the rural economy and, on that vitality build up the future prosperity of the common man is one which, as the first condition, imparts strength to both agricultural and rural industry. Only then, and in that process, will conditions have been brought about for the well-being of the common man, and, therefore, for the realisation of a commonwealth. The process should, and with wisdom and determination can, be that of co-operation ; co-operation, however, not merely in the narrower

technical sense in which it has completed fifty years of existence in this country, but in the much broader conception of co-operation as the purposive union of all the forces which work for the common good and, in particular, the co-operation which joins together in a common purpose the united strength of the Indian village with the united strength of the Indian State. It is only when co-operation is interpreted in a wider and more positive sense as a fundamental creed of action, as a dynamic instrument of change, the opposite, on the one hand, of regimentation, and on the other, of drift and stagnation, and the State effort is enjoined to the fullest extent necessary with co-operative endeavour, that co-operation will be potent force in the country's economic development. The Integrated Scheme of Rural Credit recommended by the Committee is conceived as one part, but an organic part, of this much wider endeavour.

Urgency of Implementation

The Committee lays considerable emphasis on urgency in the implementation of its recommendations, if accepted. It points out that in the past many of the measures of rural credit undertaken by Government have been in the nature of remedial action to rectify the damage already done. Most of the steps taken in connection with debt relief, for example, fall in this category. The pressing need today is to initiate measures which, if possible, will prevent damage. For that, the moment may be said to be favourable, but there is no time to lose. The Survey indicates that an upward swing in indebtedness has, perhaps, just begun after a decade or more during which a process of liquidation of past debts have been made possible by relatively good prices. It is, therefore, of the utmost importance that no delay should occur in implementing the proposals for the widening and strengthening of rural credit.

(Based on a Summary published in the Reserve Bank of India Bulletin for December, 1954).

CHAPTER X

STOCK EXCHANGE AND INDUSTRIAL FINANCE

"THE Stock Exchange is sometimes spoken of as a 'Market of Capital'. That it is not ; the capital of a company has already been found and applied to the Company's objects before its stocks and shares appear in the stock exchange lists. The Stock Exchange is a market for the shares of companies that exist ; it facilitates the transference, not of capital from one industry to another, but of shares of existing business from one owner to another. Indirectly, however, it is the means of guiding new capital into the industries in which it is most needed. By making shares readily salable, it encourages investment ; and by registering the changes in value of shares in existing companies, it indicates where new capital is needed ; if railway stock rises in value on the stock exchange, people with disposable capital are inclined to put it into new railways ; if motor shares have fallen more than shares in other industries, investors are warned not to put any more capital into the motor industry." (Clay: *Economics for the General Reader*, pp. 113-114). In this matter the stock exchange performs an important social function by directing the flow of savings into profitable channels of investments and preventing the simultaneous gluts and scarcities of capital as between different industries and mitigating the maladjustments between the supply of capital and the demands of industry.

A stock exchange by providing a ready and continuous market imparts liquidity to capital. If a person wants to realise some parts of his investments, he may do so by disposing of his stocks and shares in the market, and when he likes to invest certain funds in company shares, he can buy those from the stock exchange. Thus investments are made liquid and easily transferable and so stable. The stock exchanges provide a broad market for the secondary distribution of listed securities after their original sale as new issues.

An organised stock exchange, guided by certain prescribed

rules and regulations, ensures the safety of dealings in stocks and shares. Such an organized market is recognized by the banks, Government trusts and other insurance companies. Because of the confidence of the people in the stability of such an organization, it becomes easier to undertake dealings in securities with a sense of safety.

In the words of Prof. Marshall, "Stock Exchanges are not merely the chief theatres of business transactions ; they are also barometers which indicate the general conditions of the atmosphere of business." It thus provides a ready means for the evaluation of the securities in terms of their investment-worth according to the changes in the economic conditions of the country.

In spite of some of the benefits of the stock exchange, it often degenerates into an arena of speculation and gambling. It may be difficult to distinguish between speculation and gambling. Normally the essence of speculation lies in forecasting the price-movements and in buying or selling in expectation of profits. A speculator bases his calculations on knowledge and experience, while a gambler simply guesses without any specialised knowledge or judgment. The gamblers are just like the amateurs who are ill-informed and speculate without any knowledge of forecasting correctly the future changes in demand and supply and consequent changes in prices. Often their forecasts prove wrong, while the professional speculators forecast with wonderful accuracy. Still it is a necessity that unwholesome speculation should be held in check. The Atlay Committee, while speaking of the nature of business in the Bombay stock exchange, noticed some signs of illegitimate speculation in stocks and shares. According to the Committee, "the most sinister manifestation of speculation of Bombay in the frequent occurrence of corners appears to us to constitute the head and front of their offending. A corner is no longer a rare occurrence. On the contrary, it appears to have become a recognised phenomenon in the share market of Bombay. It is an evil *which must be suppressed* if the share market is not to become utterly demoralised and finally destroyed."

Members of the stock exchange are usually divided into two broad classes, *viz.*, brokers and dealers according to the rules of exchange and local practice.

Brokers are usually commission agents and act for non-

members. Sometimes they act as agents of fellow members as well. The transactions on the floor of the stock exchange pass between members only, as non-members are uncontrollable on account of their lack of allegiance to the stock exchange. The income of these commission-brokers is derived from their business with different clients, who pay them certain percentage as brokerage. There is a minimum scale of brokerage. But the brokers are free to charge more than the minimum rate. But competition has made the minimum rate virtually the maximum rate. Besides serving as commission-agents, the brokers are authorised to transact business on their own account. The Paris stock exchange is the solitary association which does not permit its members to deal in stock and shares in their own account.

Dealers, as distinguished from the brokers, act on their own behalf. They are professional speculators and operate largely on the market. They are responsible for the making of prices of stocks and shares according to the general conditions of demand and supply. If the purchases exceed the sales, the dealers will raise the price to a level equalising the supply with the demand. In case the supply is greater than the demand, they shall follow the opposite methods. Dealers absorb temporarily the excess supply and meet the excess demand as well. If their judgment is correct, and calculation proves true, they make profits. Should misjudgment occur they pay penalty for that by facing losses.

In New York the brokers act as links between the market and the public. They not only operate on behalf of their clients but often advise them as to what to buy or sell and when to buy or sell. The commission varies with the size of their business and they usually prefer clients with a sound financial backing. The commission-brokers may not have to deal on their own account if their commission business is lucrative and free from risks. There exists another class of brokers called "Two-dollar brokers". They act as brokers' brokers.

Working.—Dealings might be of two kinds:

(*a*) dealings for money,

(*b*) dealings for account.

Dealings for money include transactions for ready money. A *ready delivery contract* is a contract for the purchase or sale of securities, which is to be performed immediately or within a reason-

able time. In Calcutta the buyer has to arrange cash on the third day after the bargain and in Bombay a period of seven days is allowed for delivery and payment.

Dealings for the account are called "time bargains" which will be paid for or "differenced" on the next settlement day. The dealers may take advantage of any variation in the prices during the intervening period. Most of these dealings are speculative in character.

Processes Involved in Trading—

(i) An investor is required, in the first instance, to choose his broker.

(ii) The broker will then satisfy himself about the integrity and credit of his intending customer after proper inquiry and reference.

(iii) The customer will next be placing orders with the broker in any of the following ways:

(a) Buy or sell such and such shares at best. Here no price is fixed and the orders should be executed immediately at the best market price without exercising any discretion by a broker.

(b) The customer may instruct the broker to *buy or sell at specified price.*

(c) Sometimes orders are placed like "But.........it......... immediate". Sometimes the word "cancel" is used instead of 'immediate'. Such orders are to be executed immediately and if those orders cannot be executed at the specified period those are to be cancelled.

(d) Sometimes a broker places "stop-loss order" to guard against any fall or rise in price. Such a 'stop-loss order' to buy reads as "100 century at 950 stop". The broker will not take any action until the price is lower than 950. But as soon as it reaches 950 and begins to rise, the broker will buy 100 shares at the best market rate. If a customer instructs his broker to "sell 100 centuries at 930 stop", as soon as the price reaches 930 or begins to decline, he must at once comply with his customer's instructions by disposing of the shares. A stop-loss order becomes a

market-order, when the price of security reaches the stipulated level.

(*e*) Sometimes instructions are given by customers leaving discretion to the brokers.

(*iv*) As soon as orders are received, those are recorded in a rough memo and then copied in the order book. In case large orders are received, those are classified according to the nature of scrips.

(*v*) Then the authorised clerks of the brokers go to the floor of the Exchange to execute the orders. In concluding the bargain, the figures in hundred's place and thousand's place are omitted. All bargains are closed verbally on the floor and no contracts in writing pass at that stage. Particulars of the contracts are noted in a pocket-diary. The diary is divided into two parts ; purchases being entered on the debit side and sales on the credit side. Transactions are completed in certain lots prescribed by the Stock Exchange Association.

(*vi*) At the close of the business the authorised clerks return to their respective offices and record the details of the transactions from the rough scrips into *Kacha soda books*, wherefrom those are recorded again into dealings books or *Pucca soda books*. Details of brokerage and names of parties are also kept. Contract notes in prescribed forms are next prepared by the brokers, *separately for forward and ready delivery* and sent to the clients under authorised signatures and properly stamped (-/2/-). On confirmation of the contract-notes by the clients bills are submitted by the brokers accompanied by the delivery of scrips.

(*vii*) Then comes the question of settlement—settlement for ready delivery contracts and settlement for forward delivery contracts.

(*a*) As regards ready delivery contracts, cleared securities are settled through the Clearing House, while non-cleared securities are settled by 'hand-delivery' without the instructions of the Clearing House.

(*b*) Settlement in forward bargains extends over six days. On the clearance or Ticket day the members submit

to the Clearing House the *clearing lists and the delivery lists* showing the balance of securities to be taken or delivered and the net amount payable or receivable. The third day and the fourth day are devoted to the delivery of shares to the Clearing House. The fifth day is the *Pay day*, when the members submit to the Clearing House a statement of differences. On the last day, *i.e.*, sixth day, which is popularly called the *Settling day*, payments are received by the members from the Clearing House along with shares.

Budla or "Carry Over" Transaction.—A speculator, who has bought or sold a security for forward delivery, may be unable to pay for the delivery or effect delivery on the settled day and may ask for the postponement of the bargain to the next settlement. Such a process is called '*Budla*' or '*carry over*'. It is the continuance of the purchase or sale without final completion of the transactions.

A *bull* is an operator who purchases shares with a view to selling those at a profit before the day of settlement. A bull usually does not desire to take up the delivery of shares by making payments, but rather desires to make some profit by sale should prices rise in the meantime. If the prices fall, he pays for the difference. When it is observed that prices fall beyond his expectation; he may carry forward a transaction by paying a *Contango*, which is equivalent to a charge paid by a bull to the bear to enable him to renew a bargain until a later settlement.

A *bear operator* sells short in the expectation that he may repurchase those securities at a lower price on a later date. If the price appreciably falls, he gains buying at a much lower price and if the price rises, he loses as he has to buy back at a higher price than he has sold.

When the market shows signs of rising and a feeling of optimism prevails, the tone of the market is called *bullish*. But when the market is dominated by a feeling of pessimism and a declining value of securities, the tone is called *bearish*.

When the speculative purchases made by the bull operators exceed the speculative sales, it is called a *bull account* or overbought position. Similarly, when the speculative sales exceed the

speculative purchases, the position is a *bear account* or oversold position. When the tone of the market is bearish and the bears want to press down the prices still lower by spreading this pessimism, it is called *a bear raid.*

A bear usually sells in the belief that he will be able to purchase back his securities at a lower price. But contrary to his expectations, if the prices of those securities tend to go high, the bear will be compelled to start buying in order to cover his loss. Such a purchase by a bear is known as "bear covering". Similarly, when the bull begins to unload his holdings to reduce his loss, because of the fact that the prices show signs of going lower than expected, it is called *bull-liquidation.*

Backwardation is the rate paid by a bear for the purpose of renewing a bargain until a later settlement.

Financing of Budla Transactions.—When a bull operator contracts to buy certain securities which he does not pay for, he may approach the *Budliwalas* for credit to finance those transactions on the settlement day, for which a high rate of interest is usually charged by those *Budliwalas.* Besides this, the bull operator may enter into an understanding with the seller that the latter will not press for payment on the settlement day but will postpone settlement in return for some agreed rate of interest which is payable by the bull. Similarly, if the bear sells certain securities, which he fails to deliver on the settlement day, he may get over the difficulty by paying some interest to the bull, who may then be persuaded to defer delivery of shares. Thus bulls or bears accommodate one another. When the market becomes oversold in particular securities, *i.e.*, when there are more dealings in securities than can be delivered, the sellers become anxious to carry over the transactions till the next settlement and as a result the quotation for the next settlement becomes lesser than the current settlement rate. When there arises a bear account in the market on account of heavy short sales by the operators and the supply of securities runs short, the bear operators are anxious to carry over the delivery of shares even by paying *backwardation, i.e.*, a rate paid to renew a bargain until a settlement on a later date. *Budli* thus should not be construed as a loan but as a double transaction involving simultaneous purchase and sale. Such a business constitutes "the blood and bones of speculative market". Short selling has been described as

a process of selling a security which one does not possess, in the hope of a fall in price, when the sale shall be covered by a purchase.

In March, 1960 the Reserve Bank of India issued a directive prohibiting banks from financing directly the *budla* transactions, *i.e.*, purchasing for the current settlement and selling for the next settlement.

Dealings in Government Securities.—Government securities may be of the following types:

(*a*) Stocks,
(*b*) Bearer Bonds,
(*c*) Promissory notes.

Stock is a registered security which is transferable by a transfer deed without any stamp duty. While bearer bonds are transferable like currency notes, Government promissory notes may be terminable and non-terminable. Non-terminable notes are repayable at the option of the Government as there is no fixed term for such loans, while terminable loans are repayable after a fixed period. These notes are transferable by endorsement.

Transactions in the securities may be permissible either for "ready delivery" or for *account*. Forward trading in such securities is not permissible for a unit below Rs. 25,000 face value.

Short selling is a process of selling securities, which are not in the sellers' possession but which will be covered by purchases on a later date. Short sale is thus criticised for engendering speculative tendencies and for the creation of a corner. Short-selling tends to depress prices artificially. As has been pointed out by the Atlay Committee, "a corner arises when more shares than are available for delivery on the day of settlement has been sold and the buyer holds the sellers to ransom."

But short selling has certain usefulness. It gives certainty to the market and imparts liquidity to the securities. Investors are assured of a ready market by the short-sellers. Short selling facilitates arbitraging which means buying in a cheap market, and selling in a dear market. Moreover, it checks an excessive inflation of prices and acts as an adjunct to forward dealings. To stop short selling is to stop forward dealing, though at times it may be necessary to suspend short selling for a limited period in public interest. Accordingly the Bombay Stock Exchange has such a

provision that "in a crisis or emergency or when it is obvious to the Board that a crisis is at hand or that a fair or normal market may not exist and the Board is satisfied that a temporary suspension of short selling is in the public interest, the Board shall prohibit short selling in any security, provided that such suspension shall be effective for 24 hours only and that for any longer period shall be effective with the previous consent of the Government."

Arbitraging may be defined as "a special form of trading which is based upon the disparity in quoted prices of the same or equivalent commodities, securities or bills of exchange."

Cum Dividend: (*c.d.*): Cum means 'with', *i.e.*, with dividend.

Ex-Dividend: When a security has been sold ex-dividend it means that the seller reserves the right to take the dividend that will be declared next in spite of the fact that he has disposed of the security.

Buying-in and selling-out: Buying-in is the process for the enforcement of delivery of securities by buyer, when the seller has failed to deliver the shares within the stipulated time. Selling-out is resorted to by the sellers, when the buyer fails to take delivery of shares by paying the same.

Recommendations of the Morison Stock Exchange Enquiry Committee, 1936.—The Committee recommended the control of remisiers, who are described as sub-brokers, by demanding deposit from them of Rs. 5,000 as a guarantee of good faith. Besides this, a remisier should be called upon to pay an annual subscription of Rs. 250 and is to get himself registered with the stock exchange. Moreover, he is to produce a clearance certificate from the broker he leaves.

Speculative dealings by employees should be prohibited unless they obtain written consent from the employers. A system of margin should be adopted, which will then "act as a definitely restrictive influence on that class of speculation which we are most anxious to discharge, namely, speculation conducted by financially weak individuals."

The Committee recommended a minimum scale of brokerage, and also that if a member advises another member to do any business, the latter should remunerate himself out of, and not

in addition to, the former's commission and the contract note should contain such a provision.

The Committee recommended the discontinuance of blank transfers.

Besides this, the Committee made certain valuable recommendations for the improvement of the administrative machinery. Their recommendations were mainly directed towards "restricting as far as possible the facilities provided for reckless gambling while at the same time leaving the way for the exercise of what we claim as a perfectly legitimate function of Stock Exchange."

Reform of the Stock Exchange

In the past there was a hectic speculative activity on the stock exchange, which affected adversely the national economy. There are some speculators who have no intention of payment and delivery, but deal for the differences and depend on carry-over facilities. The absence of any system of margin encourages over-trading and excessive speculation. To check some of these unwelcome activities of the stock exchange, a Special Research Officer was appointed by the Government to enquire into the question of stock exchange reforms. It is learnt that the recommendations have been made to the Government for reform of the stock exchanges on certain lines, which have not yet been made known to the public.

Under the present rules of stock exchanges, any man can become a member of the Exchange without any requirement of training or apprenticeship. As a result, untrained persons, having no knowledge of the intricacies of security transactions, get access to the market. It is, therefore, necessary that stock exchange rules should provide for a period of training or apprenticeship for the members and prescribe certain minimum qualifications.

A stock exchange should look to the interests of the investors and accordingly stocks and shares of the financially sound companies should be listed. It should not be understood that the mere quotation of shares on the stock exchange list speaks of the soundness or stability of the companies concerned. But as a matter of fact if normal listing requirements are fulfilled, the stock exchange permits dealings in shares of any company, sound

or unsound. The Bombay Stock Exchange listing regulations require that fifty per cent of the share capital of a company must be subscribed by the public, before those securities are permitted to be dealt in on the floor of the exchange. It is suggested that the listing committee must be thoroughly satisfied about the prospects and soundness of a company before there can be any dealings in those securities.

It is suggested that there should be some sort of outside and Government representation on the governing body of managing committee of the stock exchange to produce some moral effects.

It often appears that the brokers allow their clients to overtrade and they themselves indulge in excessive speculative dealings on their own account. As a result, carry-over facilities were availed of and forward business was transacted under the guise of the ready market in spite of the suspension of forward dealing in October, 1942, by the Government of India. In September, 1943, *the Budla transaction was banned.* But these measures also failed to check some of the malpractices. In practice, delivery and payment were postponed by mutual agreement by way of evasion of the law which prohibited any facility for Budlà business. As has been pointed out by Mr. K. R. P. Shroff, "the administrative difficulties were multiplied and handicaps increased and even more serious was the development of grey markets that sprang into being and thrived in the streets outside the control of the stock exchange. A free, broad and active market ensuring liquidity of holdings and continuous adjustment of values from point to point in the smooth flow of moving equilibrium was in a large measure destroyed by the unfortunate tampering with the trading machinery......Backwardation, a variety in normal times, became the order of the day in the grey markets and one scrip after another was juggled with till there was not one of the note felt out of the game". It has been contended that forward dealing ensures the continuity of the market and that its abolition is harmful as well as undesirable. Forward dealing may at best be controlled by a special machinery set up for this purpose. It is suggested that a Government machinery should be formed to co-ordinate the activities of the various stock exchanges operating in India, which differ so widely

in practice and rules and that these rules should be framed on an all-India basis to bring about certain uniformity.

In Bombay, a class of members carries on *tarawani* business, which gives a handle to speculation. These tarawaniwalas would continuously go on buying and selling at a small range of fluctuations. Their activities are no better than gambling in differences. There is a necessity for classification of members into brokers and jobbers and from the beginning of the year it is desirable for the members to declare whether they shall act as brokers or jobbers. Their choice of business in this regard should be scrupulously adhered to.

The absence of the system of marginal deposits is a prolific source of speculative activities. It is desirable that the dealers should deposit margin in advance for their transaction and must never allow the margin to fall. This will eliminate those dealers who indulge in speculation on securities without sufficient capital.

The system of blank transfer is so widely used that it generates speculative tendencies and unauthorised dealings as well. This system enables the dealers to avoid stamp duty, which would otherwise be required for the registration of shares in dealers' names. It is, therefore, necessary that a definite time limit, say for three months, should be assigned for the registration of shares held in blank.

The Stock Exchanges have since been authorised to frame bye-laws to regulate or prohibit the use of blank transfers. Section 270 of the Securities Contracts (Regulation) Act 1956 has helped restrict to a certain extent the use of blank transfers by giving the person whose name appears in the register of a company the right to claim the dividend.

Private compromise is often made, though it is penalised under the rules of the Bombay Stock Exchange. The Morison Committee did not like the idea of such compromise, which was used as a cover for avoiding default.

It is often found that authorised clerks of some members carry on securities transactions on their own accounts through those members. Such a practice might be misused, if the clerk concerned, while executing large orders, would first deal on his own account on favourable terms and thus cause loss to his employer or client.

So it is advisable that such a practice, which is subject to much abuse, be abolished.

Suggestions have been made to impose a sales tax on forward dealings to restrict speculative activities. But the imposition of such a tax is strewn with certain administrative difficulties, which may check the flow of capital into industries.

For the popularity of shares amongst the investing public, it is suggested that the denominations of shares should be lessened and dealings in shares in small lots should be permissible. Shares of larger denominations are more suitable for speculation and covering than shares of smaller denominations.

These are some of the suggested measures for the reform of the stock exchange for eradicating a number of malpractices, which have since developed on a wide scale. Besides the above, what is more important is the understanding by the investors of the technique of investment, unswayed by market tit-bits, on the basis of a careful examination of the company's Balance Sheet and its working results. The trend of sales should be observed along with the expenditure items. If the sales decline and the expenditure items increase without any corresponding expansion in turnover, there are reasons to be pessimistic about the prospects of that company. Investors should ascertain the various sources of income and whether there is any possibility of any source being blocked by future developments. More earnings alone should not be a guide to any calculation. The trend of earnings on the effective capital employed should be examined. The taxation policy of the Government should be taken into consideration while calculating the dividend. It may not be possible for a company to maintain the dividend if a larger sum is to be provided for increased taxation. Next comes for scrutiny the depreciation and reserve policy of the company. "If block has already been depreciated to a low level and if the existing reserves are colossal any further allocation for depreciation on the same scale is open to serious objection. This means that a substantial portion of the profits is ploughed back or diverted to channels other than that of shareholders. In such a case the true equity of shares is rendered a misnomer." On the other hand, the declaration of dividends in total disregard of the necessity for providing for depreciation and reserves is condemnable. Then attention may be paid to the other position of the

company, namely, capital structure, classes of shares and dividend arrangements, comparison of block with fixed finance, *i.e.*, how much block is being financed by fixed capital, valuation of floating assets, working capital, and the break-up value of the company. The break-up value may be calculated by evaluating its assets less liabilities after allowing for a probable loss or possible profits on the Balance-Sheet values. The net assets thus calculated should then be apportioned on the following principles:

(*a*) if the preference shares have priority as to capital on a winding up as well as to dividends, they will be valued at par, and the balance will be divided by the number of ordinary shares which will give the value for one ordinary share ;

(*b*) if the preference shares rank equally with ordinary shares on a winding up, the net assets will be deemed to be the combined property of these shares, and by dividing the net assets so arrived at by the combined nature of these shares, preference, ordinary and both, it will be possible to get the value of one preference or ordinary share.

At present there is no legislation for the regulation and control of stock exchanges in India except in the State of Bombay. In June. 1951, the Government of India appointed a Committee with Mr. A. D. Gorwala as the Chairman in order to assist them in formulating legislation for the regulation of Stock Exchanges and of interest in securities. The report of the Committee was submitted to Government in the middle of July, 1951 and a draft bill has also been prepared.

Factors Affecting the Stock Exchange

(*a*) Public opinion about certain stocks and shares affects the movements in the prices to a great extent.

(*b*) Monetary factors are responsible, in a large degree, for the fluctuations in the value of the stock exchange securities. In case of monetary stringency, its repercussion is inevitably felt on the stock exchange. Similarly, when the money market is easy, the tone of the stock exchange becomes optimistic and the speculators become busy. A decline in the borrowing rate will induce speculators to

this should not indicate that any favourable war news will always improve the market, but that will depend upon the psychology of the speculators. So it has been rightly observed by Hartley Withers that "Politics and finance are becoming so hopelessly entangled and have a very direct and telling influence on prices."

(*e*) Duties and taxes will influence values of stocks and shares according to their repercussions on the minds of the investors. A duty on foreign imports is expected to cause a rise in the local shares. An imposition of fresh tax, like the Excess Profit Duty, tends to bring about a perceptible decline in the share price. Similarly, the enhancement of the railway freight on goods etc., tends to cause a decline in the share value, as it is feared that the increased freight is an additional burden on industries.

(*f*) The prospects of dividend and earnings play a large part in the determination of the value of shares. Increased dividend often creates the interest of the speculators in the shares concerned and brings about an increase in their prices. If the prospects of earnings diminish, the interest in those particular shares also subsides, so the prices as well. As for example, the recommendation of the Economic Programmes Committee to A.I.C.C. to restrict maximum dividend to 5% had a depressing effect on the stock exchange, as it means declining prospects of earnings.

(*g*) Change in the capital structure of a company, change in the Board etc., also influence the stock exchange and the value of stocks and shares of the particular company or companies concerned.

Industrial Finance

The managing agency system originated in our country during the second half of the 19th century. The managing agents were in fact the pioneers in many industries like jute mills, cotton mills, tea gardens and coal companies. Besides providing finance for the promotion of new industries, they trained up a band of efficient ...gers The managing agency firm may be described as a

partnership firm or a limited company composed of a group of individuals possessing considerable wealth and business acumen. They were the financiers of a new concern, managed its affairs, acted as its agents for the purchase of raw materials, stores, machines, etc. and also for the marketing of its products.

The managing agents either granted direct loan to the company or guaranteed the loan made by any other company. The managing agents command such a unique reputation that their names attract finance from outside. Not only do the managing agents subscribe to the shares of the new concern but also help considerably in the placing of those shares in the market and thus discharge the function of underwriters and industrial banks. Naturally it is not difficult to understand why the industrial undertakings in India are so much dependent on managing agents for finance.

Defects of the Managing Agency System of Finance

1. Industries in India tend to be controlled by a handful of financiers, as a result of which "finance, instead of being the servant of industry, has become its master." These financiers control the affairs of the industries not because of their ability but because of their command over adequate financial resources. The failure and liquidation of a number of cotton mills in Bombay point to the incapacity and lack of ability on the part of these financiers.
2. Where a managing agency firm controls a number of industries, the difficulties of one concern recoil adversely upon the other concerns as well.
3. Sometimes the otherwise sound companies under the management of the managing agents had to suffer because of the inadequacy of the financial resources of the agents themselves. Banks are found withdrawing credit from a concern which is otherwise functioning satisfactorily simply because the managing agents have become financially weak. The transference of funds from the more successful concerns to weaker ones, both managed by the managing agents, conspires to prejudice the confidence of

the investors. Such a state encourages interlocking of funds.

4. The managing agency system of finance is responsible for a spate of speculation in stocks and shares. Any sign of financial weakness of the managing agents leads the rival group to lower those shares with a view to grabbing the management of that concern. Many of the concerns in the Bombay Stock Exchange have, in the words of Dr. P. S. Loknathan, "been the result of the inter-dependence between the managing agents' external acti-vities and their functions as financial agents of the com-panies they managed."

5 It has been pointed out by a banking expert that the managing agency system adversely affects joint-stock banks and creates a vicious circle. "The banks are spoiled by the managing agency system and the managing agents are spoiled by the banks, because the banks practically force the joint-stock companies to take the managing agents. The banks are quite happy that companies are managed by managing agents as it gives the banks their signatures for the loans." The banker is thus not interested in develop-ing any other method of financing industry ; he has two signatures, and there is no reason why he should favour another system which may be quite good for industry, but deprives the banker of another signature.

6 The managing agents impose such agreements upon their concerns in terms of which they exact excessive remunera-tion by way of commission on output, profits as well as on sales. When commission is payable on production, the managing agents are often actuated by considerations of personal gain, which leads to the manufacture of coarse goods and overstocking regardless of market conditions. Likewise, the system of paying commission on sale is fraught with the same evil. It induces them to sell regard-less of the prices at which their goods are being disposed of. Besides this, the managing agents are accused of taking secret commission.

7. The managing agency system has led to the concentration of control in a few hands and a centralised control affords

greater opportunities for juggling with accounts, orders, for unfair purchase of raw materials, crooked dealings in shares, and for the subordination in a variety of ways of some one company's interest to that of another.

Considering the above defects the Indian Companies Act, 1936 (Sections 87 A to 87 I since repealed) laid down certain provisions governing the activities of the managing agents. It was laid down that no managing agents could be appointed to hold office for more than twenty years at a time and even in the case of existing agencies the period of office must come to an end after 20 years. It is also provided that a company may remove a managing agent if he is convicted of certain criminal offence. The appointment, dismissal and variations in terms of appointment are made subject to the approval of shareholders. The remuneration of the managing agent has also been fixed. Under the Act no company under a managing agent can make any loan to or guarantee any loan made to any other company by the same managing agent. Similarly, no company can employ its funds in the purchase of shares and debentures of another company under the same managing agents. No managing agent can nominate more than one-third of the total number of Directors and the rest of the Directors shall be elected by the shareholders. The granting of loans to Directors is prohibited and no Director can hold office of profit except with the consent of the shareholders.

Similar provisions have also been made in the Companies Act, 1956. It, inter alia, also provides that the Central Government may declare that as from a specified date all companies in certain classes or types of industry or business shall cease to be managed by managing agents at the end of 3 years from the specified date or on the 15th August, 1960, whichever is later, after which the managing agency company shall not be managed by any managing agents. In all other cases, the appointment or re-appointment of managing agents by companies must be approved first by the company itself at a general meeting and then by the Central Government. Managing Agents shall not be appointed for a period of more than 15 years and in cases of re-appointment not for more than 20 years at a time. After the 15th August, 1960, no person shall hold office at the same time as managing agent in more than 10 companies. The managing agents shall

not ordinarily be paid by way of remuneration any sum in excess of the 10% of the annual net profits of the managed company. An additional remuneration can be paid only if such payment is sanctioned by a special resolution of the company and approved by the Central Government. Thus the Companies Act, 1956 does not seek to abolish the system but merely prescribes certain standard of management.

Sources of Supply of Fixed Capital

Fixed capital for industries is raised from the public by way of subscriptions to shares and debentures. Of these shares play the prominent role, while debentures the secondary role. The figures given below will explan the position:—

	Joint-Stock Company in Calcutta List	Joint-Stock Company in Bombay List
Share-Capital (In crores of rupees) ...	76·37	52·83
Debentures (In crores of rupees) ...	8 65	17·51

Debentures in India are not so very popular as shares owing to a variety of reasons. *Firstly*, there is no organized agency for the issue of debentures. *Secondly*, banks are not interested in debentures as they command no ready market. *Thirdly*, industrial concerns issuing debentures are not held high in the estimation of banks, which feel hesitant to extend financial accommodation to these concerns, as debentures have the first charge on the assets of these concerns. According to the estimates of the Central Banking Enquiry Committee, out of 100 units of capital 75% were ordinary shares, 16% preference shares and only 9% debentures in India. On the other hand, in British Industry the proportions varied from 47 for ordinary shares, 33 for preference shares and 20 for debentures.

Sources of Working Capital

The following are some of the sources of working capital for industries:

(*a*) Public deposits,

(b) Private deposits,
(c) Advances by indigenous bankers and shroffs,
(d) Advances by joint-stock banks.

The feature of public deposits is noteworthy in Bombay and Ahmedabad. These are not so popular in other parts of India. The mills of Bombay benefited much from such public deposits, which were kept for pretty long years bearing interest @ 4½% to 6½% p.a. These deposits served to provide the mills with their working capital. But this system was not free from certain serious drawbacks. Such deposits bred a tendency for speculation or overtrading in cotton. There was further the risk of such short-term funds being locked up in the extension of plant and machinery. Finally, panicky withdrawals of such deposits might lead the industrial concerns into a difficulty, as these deposits were called "fair weather friends". But the Chairman of the Ahmedabad Mill Owners' Association pointed out that 95% to 98% of the public deposits were fixed yearly deposits and the mills got in advance seven to eight months' notice before withdrawal. Inter-deposits between mills for a period of 5 to 7 years were popular in Ahmedabad. The following table brings out the importance of public deposits in the financing of the cotton mills in Bombay and Ahmedabad:—

	Bombay Figures for 64 Mills		Ahmedabad Figures for 56 Mills	
	Lakhs of Rupees	Percentage to Total Advances	Lakhs of Rupees	Percentage to Total Advances
Amount loaned by managing agents ...	532	21%	264	24%
Amount loaned by banks ...	226	9%	42	4%
Amount of public deposits ...	273	11%	426	39%
Amount of share capital ...	1,214	45%	340	32%
Amount of debentures issued ...	238	10%	8	1%

Private Deposits.—Working capital is raised from private deposits from industrialists, friends and the managing agents. In the above table the managing agents themselves provided Rs. 796

lakhs as against Rs. 699 lakhs of public deposits. Such private deposits are reported to have saved many cotton mills in Bombay and Ahmedabad and tea gardens in Bengal and Assam from liquidation.

Indigenous Bankers and Shroffs.—The indigenous bankers help industrial concerns by keeping with them their deposits. Small industries often do approach the indigenous bankers for finance with a view to avoiding the formalities of bank finance. But the influence of these bankers over industrial finance is gradually waning due to the competition of joint-stock banks.

Joint-Stock Banks.—Joint-stock banking in India developed on the model of English banking which always fights shy of industrial finance. Usually joint-stock banks cannot invest in any industry unless it is self-supporting or running on a profit. Provided the industry is established and earns profit, joint-stock banks may at best come forward to supply working capital for industries by granting overdraft or cash-credit for a short period. As a rule joint-stock banks will not be providing initial or block capital for industries. Even the Imperial Bank fo India (now the State Bank of India) which is the largest joint-stock bank in the country, was prohibited until 1934 from granting advances for more than six months or on the security of industrial shares or immovable properties. Usually, the joint-stock banks insist on keeping 30% to 40% of the value of the assets as margin. Disregard shown by banks to the existence of valuable block capital as general security for loans adds to the hardships of the industrial concerns. Moreover, the banks do not take into account the personal credit of the industrialists so much while making advances. They cannot afford to keep on their staff persons possessing technical knowledge about industrial concerns, so that the finance may be well-directed and properly placed. The terms of industrial finance are often found onerous. The managing agents are called upon to execute personal guarantee for the advances, in spite of hypothecating in the bank's favour the entire undertaking of the companies. Moreover, it is complained that the rate of interest charged for finance is more than what the traffic can bear. So it is understandable from the foregoing table that bank advances form a small percentage (*i.e.*, 4% to 9%) of the total advances obtained by industries from other sources.

In England and the U.S.A., insurance companies are suppliers of industrial finance. Insurance companies in England invest a quarter and one-third of their funds in industrial enterprise and securities of railway companies. But in India the investment of insurance funds is compulsorily to be made @ 55% in gilt-edged securities under the statute with the result that the insurance companies are left with little resources to employ profitably for the financing of industries and new enterprises. In England, banks are indifferent to the needs of industries. When banking attained a developed form in that country, industries were already provided with the financial mechanism. So the industries could raise finance independent of the help of the commercial banks. The English pattern of banking indifferent to the industrial needs was imported in our country on the presumption that what was suitable to Great Britain might be equally suitable to Indian conditions. But as India is industrially so undeveloped, she will have to quicken industrialisation in order to make rapid strides towards the way of prosperity and it is undoubted that industrialisation cannot fructify without the support of banks. In this respect India cannot but take out a leaf from the chapter of German banking which had to take a forward step in the industrial regeneration of that country after the first world war. Within limits of safety, Indian banks, specially the established and the largely capitalised banks will have to help in the promotion of new industrial enterprises on the German "Konsortium" basis. But it is to be remembered that Indian commercial banks can lend support to the programme of industrialisation up to a certain extent only which marks the line of safety and beyond that, their tasks will have to be discharged by specialised institutions like the Industrial Finance Corporations, etc.

Industrial Finance Corporation of India

It is a happy augury that the Government of India showed sufficient awareness of the need for the speedy industrialisation of India by establishing an Industrial Finance Corporation. The Corporation started in 1948 with a capital of Rs. 5 crores, divided into 2,000 shares of Rs. 25,000 each. The Government of India and the Reserve Bank have subscribed to Rs. 2 crores of shares and

the balance has been allotted for subscription to scheduled banks, insurance companies, Investment Trusts and co-operative banks. The Corporation is managed by a Board of Directors composed of 13 persons (including the Chairman) of whom 4 are nominated by the Central Government and 2 by the Central Board of Directors of the Reserve Bank of India. The shareholder scheduled banks elect 2 Directors and 2 each are elected as representatives of insurance companies, Investment Trusts and co-operative banks. The Corporation has, for the present, started four offices in Calcutta, Bombay, Madras and Delhi.

The Corporation has been set up with the object of supplementing existing facilities available for the supply of medium and long-term capital to large-scale industries. The Corporation is authorised to grant secured loans repayable within 25 years, to guarantee loans raised in the market by industrial concerns, to underwrite the issue of stocks, bonds and debentures and also to retain such stocks, bonds or debentures as it may have to take up in fulfilment of its underwriting obligations subject to the condition of disposing of those stocks, bonds and debentures within 7 years. The Corporation may issue bonds to the extent of ten times the amount of its paid-up capital and reserve fund. The Corporation is authorised to receive deposits for not less than 10 years provided the total deposits do not exceed Rs. 10 crores. It is not authorised to grant a maximum loan to a single borrower exceeding Rs. 1 crore. The Corporation may, with the previous sanction of the Government, borrow funds from the International Bank for Reconstruction and Development. The Government will guarantee dividend for the present not exceeding 2½%. When the reserve fund equals or exceeds the share capital, the rate of dividend may be raised to a maximum of 5% and the balance of profit shall be transferred to the Central Government. The Corporation has removed a long-felt want and is sure to accelerate the pace of industrialisation in our country.

During 1948-1961 the Industrial Finance Corporation of India sanctioned loans aggregating Rs. 105·82 crores of which Rs. 57·35 crores were disbursed. In view of the tight monetary conditions in the money market, the Corporation granted accommodation of working expenses also, thus deviating from its general policy. The outstanding amount of loans at the end of June 1961 was Rs. 42·23

crores. During the year 1960-61 the Corporation sanctioned loans in foreign currencies of the equivalence of Rs. 4·30 crores. It approved 9 applications for Rs. 13·29 crores for guaranteeing deferred payments and agreed to underwrite shares for Rs. 2·32 crores. In April 1960, the Development Loan Fund of the U.S.A. Government sanctioned a loan of 10 million U.S. Dollars to the Corporation for being loaned to industrial concerns which apply for foreign exchange loans.

The following suggestions have been made by Dr. S. K. Basu to improve the working of the Corporation:—

(*a*) The Corporation has confined its financial assistance to loans and advances against mortgage of tangible assets. Its scope, which had been considerably restricted by prohibiting it from subscribing to the share capital of its industrial customers, is now further circumscribed. Government should consider the desirability of authorising the Corporation to take up redeemable and non-redeemable preference and even ordinary shares in the industrial companies from the point of view of adjusting its methods of finance to the peculiar needs and merits of each particular case. In the present depressed conditions of the capital market, a reconsideration of its policy by the Corporation in this respect may prove to be of great advantage to the industrial concerns.

(*b*) The maximum period for the loans so far allowed is 15 years and has ordinarily been 12 years. The period allowed is much shorter than that permissible under the Act and is likely to prove a handicap to many concerns. In cases where some years would be required for development, the better and sounder method of financing to be adopted by the Corporation should be the taking up of redeemable preference shares with or without cumulative dividends. But for that the Act would have to be amended.

(*c*) Another defect in the organization of the Corporation is the absence of a Department of Economic Research. The Corporation should consider the desirability of engaging an Economic Adviser or a Director of Economic Research.

(*d*) The Corporation should steer clear of another danger, that of extending its assistance indiscriminately to industrial concerns with which its directors or their friends are closely associated. Under the Act there is no restriction upon the Corpo-

ration's powers to assist the concerns in which the directors are directly or indirectly interested.

The Industrial Finance Corporation Act, 1948 was further amended in 1955. The amending Act provides, among other things, for a Central Committee instead of an Executive Committee of the Board of Directors, and the appointment of a stipendiary Chairman to be assisted by a General Manager in place of the honorary Chairman and a paid whole-time Managing Director. Those amendments were made in pursuance of the recommendations of the Industrial Finance Corporation Enquiry Committee. Among the other important amendments, mention may be made of the provisions for (*i*) the grant of right to the Corporation to borrow from the Central Government and to lease any property pledged or mortgaged to the Corporation and (*ii*) the removal with the permission of the Central Government of the seven-year limit in respect of the period up to which the Corporation may hold any stocks, shares, bonds or debentures in fulfilment of its underwriting liabilities. The amending Act also enables industrial concerns, formed with the object of engaging in the manufacture or processing of goods, to become eligible for financial assistance even before they start production. The Act was again amended in November, 1957. The Corporation was authorised to accept deposits also from State Governments and local authorities and to guarantee deferred payments by importers who were able to make such arrangements with foreign manufacturers. The Amendment Act of 1960 further empowered the Corporation to guarantee loans raised by industrial concerns from scheduled banks and State co-operative banks. It also authorised the corporation to subscribe directly to stocks or shares of any industrial concern.

The Industrial Finance Corporation Enquiry Committee made a number of suggestions on matters of policy. For example, it suggested that (*a*) *no loans* shall ordinarily be granted to industries where the 'saturation point' has been reached, (*b*) the Government should issue directive to the Corporation regarding the principles to be followed by the latter in granting loans, (*c*) Government should give to the Corporation a clear indication as to which regions should be treated as backward with a view to enabling the Corporation to give preference to such areas and (*d*) the Corporation should not participate in equity or risk

capital until the Reserve Fund of the Corporation has aggregated Rs. 5 crores. Most of these recommendations were accepted by Government.

State Financial Corporations

The State Financial Corporations Act, 1951 was passed to enable the State Governments to establish similar Financial Corporations for providing long-term credit to medium and small-scale industries. Under the Act the authorised capital of a State Financial Corporation shall not be less than Rs. 50 lakhs and more than Rs. 2 crores. So far such corporations have been set up in about 14 States. In Madras, the Madras Industrial Investment Corporation Ltd. performs the functions of such corporation. The share capital of each corporation is guaranteed by the State Government as regards repayment of the principal and the payment of the dividend. The public can subscribe to its share capital to the extent of 25% of the total. The corporation can, however, accept deposits from the public for a period of five years and borrow funds from the Reserve Bank against the Central and State Government securities, repayable within ninety days. It is managed by a Board of ten directors. The State Government appoints the Managing Director in consultation with the Reserve Bank and nominates three other directors. The Reserve Bank and the Industrial Finance Corporation of India nominate one director each. The scheduled banks, insurance companies, investment trusts and co-operative banks elect three directors.

The State Financial Corporations Act was amended in 1956. The main objects of the amending measure were: (1) to remove certain difficulties experienced in the actual working of the Act during the last few years ; (2) to enable a group of two or more States to establish, by agreement among themselves, a joint financial corporation for them ; (3) to provide for the extension of the jurisdiction of an existing financial corporation of a State to another State by agreement ; (4) to empower the State Financial Corporations to undertake agency functions on behalf of the Central Government, a State Government or the Industrial Finance Corporation of India ; (5) to enable the State Financial Corporations to take short-term loans from the Reserve Bank ; (6) to provide for

the grant of financial accommodation by the Corporations to small-scale and cottage industries, not having sufficient tangible assets, against the guarantee of a State Government or a scheduled bank or a co-operative bank ; (7) to vest the Corporations with certain powers for the efficient management of the industrial concerns taken over by them ; and (8) to empower the Reserve Bank to carry out, at the instance of the Central Government, inspection of the working of State Financial Corporations.

The total paid-up capital of such Corporations stood at Rs. 15·23 crores, reserves at Rs. 0·11 crore and bonds and debentures at Rs. 7·17 crores. They sanctioned total loans of Rs. 31·1 crores of which Rs. 22·2 crores were actually disbursed till the end of March, 1961.

FINANCING OF SMALL-SCALE INDUSTRIES

With a view to liberalising financial assistance to small-scale industries, the Government of India indicated to the State Governments in June, 1955 that they would be prepared to place funds at the disposal of the State Governments so as to enable them to liberalise their rules for the grant of loans up to certain limits to small-scale industries under the State-Aid-to-Industries Rules or through the medium of co-operative banks to other agencies. The State Bank of India, in consultation with the Reserve Bank of India, has taken the initiative in devising a scheme for co-ordinating effectively the activities of the co-operative credit organisations, commercial banks and the State Financial Corporations, in order that the credit requirements of small industries might be adequately met.

Besides, a Corporation called the National Small Industries Corporation was started in September, 1955 for the purpose of promoting the development of small industries. The Corporation has introduced a scheme for hire-purchase, on easy instalments, of machinery or equipment needed by small industries. The initial deposit which is payable in two instalments, is 20-40% and the rate of interest is 4½% per annum.

It may be mentioned that, in pursuance of one of the recommendations of the informal conference on rural finance convened by the Reserve Bank in 1951, the Reserve Bank of India Act was

amended in May 1953, to provide finance for cottage and small industries as are approved by the Bank's Central Board of Directors. The handloom industry has been approved by the Board as one eligible for financial assistance from the Bank under this provision, and finance is proposed to be made available through State co-operative banks at a concessional rate of $1\frac{1}{2}\%$ below the Bank rate.

National Industrial Development Corporation Ltd.—The National Industrial Development Corporation Ltd. was established on October 20, 1954. This Corporation is expected to be an important instrument for securing the harmonious development of industries in both the public and private sectors. The object of the Corporation would primarily be the development of industries, particularly those which are necessary to fill the gaps in the industrial structure. It will undertake financing of industries only in so far as it is incidental to such development. It will give priority to the establishment of the manufacture of capital goods, machinery and equipment for other industries. It will take up the study and investigation of industrial schemes, and, in implementing them, will try to secure, where possible, the maximum use of industrial equipment, experience and skill available in the private sector. In other cases, it will itself set up industries, which might in their turn lead to the growth of ancillary industries in the private sector.

The primary function of the Corporation is to promote, establish and operate schemes likely to advance the industrial development of the country. For this purpose, it can render assistance to any type of industrial undertaking, whether it is owned or managed by Government, statutory body, company, firm or individual. The assistance can be provided in the shape of capital, credit, machinery, equipment or any other type of facility. The Corporation can provide finance to industrial undertakings in different forms. Thus, it can grant loans and advances to industries. It can subscribe to, underwrite or deal in the shares and debentures of companies. It can also guarantee loans and advances to industries, as well as issues of shares and debentures made by companies. Its own capital can be invested directly in companies formed for running an industrial undertaking approved by it. Certain powers have been granted to the Corporation in order to enable it to exercise control over industrial undertakings with which

it is connected. Thus, it can manage, control or supervise a concern by nominating directors or advisers or otherwise collaborating with it. It can enter into partnership or any other arrangement for joint working with a concern. It can also promote, establish or assist any concern formed with a view to setting up or running an industrial undertaking.

The Corporation has been registered with a paid-up capital of Rs. 1 crore, which has been provided entirely by the Government of India. The Corporation is empowered to increase its financial resources by issuing shares and debentures. It can also receive grants, loans, advances or deposits from Central or State Governments, banks, companies or individuals.

The Corporation will have a minimum of 15 directors and a maximum of 25 directors. By the inclusion of industrialists, scientists and other experts on the Board of Directors, the Corporation would be able to integrate the development of public enterprises established by it with development elsewhere and thus help in securing a synthesis of the public and private sectors.

Industrial Credit and Investment Corporation of India Ltd.—The Industrial Credit and Investment Corporation of India Ltd was incorporated under the Indian Companies Act on January 5, 1955 for the purpose of assisting industrial enterprises within the private sector of industry in India. In general, the Corporation will: (1) assist in the creation, expansion and modernisation of such enterprises; (2) encourage and promote participation of private capital, both internal and external, in such enterprises; and (3) encourage and promote private ownership of industrial investments and the expansion of investment markets. In particular it will (*i*) provide finance in the form of long or medium term loans or equity participations; (*ii*) sponsor and underwrite new issues of shares and securities; (*iii*) guarantee loans from other private investment sources; (*iv*) make funds available for re-investment by revolving investments as rapidly as is prudent; and (*v*) furnish managerial, technical and administrative advice and assist in obtaining managerial, technical and administrative services to Indian industry.

The authorised capital of the Corporation is Rs. 25 crores, divided into 500,000 ordinary shares of Rs. 100 each, and 2 million unclassified shares of Rs. 100 each. The issued capital

at present is Rs. 5 crores, comprising 5 lakh ordinary shares of Rs. 100 each issued at par. Each share will entitle its holder to one vote. Several Indian banks and insurance companies and certain of the directors of the Corporation and their friends and associates have agreed to take up shares to the extent of Rs. 2 crores. Certain nationals and corporations of the U.S.A. have agreed to subscribe Rs. 50 lakhs. The British Eastern Exchange Banks and certain U.K. and other Commonwealth insurance companies and other British companies have agreed to subscribe Rs. 1 crore. The remaining shares for Rs. 1·50 crores were offered for public subscription ; the subscription list was open from February 3 to February 14, 1955, and the issue was reported to have been over-subscribed.

The Government of India have agreed to advance to the Corporation a sum of Rs. 7·50 crores, free of interest, repayable in 15 equal annual instalments after the expiry of 15 years from the date of the advance. The advance will rank for payment only after payment of all outstanding debts and liabilities and the paid-up share capital of the Corporation ; each annual instalment as it falls due will, however, be treated as a debt of the Corporation and not as part of the advance outstanding. In the event of liquidation of the Corporation, its surplus assets will be divided between the holders of the ordinary shares and the Government of India in proportion to the paid-up ordinary share capital and the advance outstanding. If liabilities exceed assets by 20 per cent of the aggregate of the paid-up share capital and the advance outstanding, a consultation will take place between the Government of India, the Corporation and the International Bank for Reconstruction and Development (I. B. R. D.) to examine the situation and prospects of the Corporation, and to determine what remedial actions may be recommended to the Corporation. If liabilities exceed assets by 30 per cent., the Government of India, in consultation with the I. B. R. D. and the Corporation, will be entitled to apply to the Court for an Order for the winding up of the Corporation. So long as there is any advance outstanding, the Government of India will be entitled to appoint, maintain and remove one Director on the Board of the Corporation to represent it ; this Director will neither be liable to retire by rotation nor be required to hold any share qualification.

The International Bank for Reconstruction and Development has agreed to lend to the Corporation, from time to time, an amount in various currencies equivalent to $10 million. Repayment of the principal, interest and other charges on the loan has been guaranteed by the Government of India. The Development Loan Fund has sanctioned in 1960 a further loan of U.S. $ 5 million to the Corporation.

The Government of India and the Corporation intend that the membership of the Corporation should be broadly distributed and that there should be no undue concentration of control. To ensure this, the Board of Directors will exercise their rights with respect to registration of transfer of shares so as to prevent any one person or company or group of affiliated persons or companies from acquiring effective control of the Corporation. Any dispute between the Government of India and the Corporation as to whether effective control of the Corporation has been acquired may be referred to arbitration. If the arbitrator determines that such control has been acquired, the outstanding Government advance will have to be repaid by the Corporation at the end of a reasonable period fixed by him, unless appropriate remedial measures are taken.

Unclassified shares may be issued by the Corporation with a preferential or qualified right to dividends and in distribution of the assets and with a special or without any right of voting. However, no shares can be issued without the sanction of the Company in General Meeting (*i*) unless they are offered to the existing shareholders in proportion to the shares held by them (irrespective of the class of shares) and (*ii*) if the aggregate nominal amount of preference shares issued exceeds the aggregate nominal amount of the issued ordinary shares of the Corporation.

The Corporation is empowered to borrow, provided the amount borrowed and guaranteed by the Corporation, does not exceed three times the aggregate of (1) the unimpaired capital, (2) the outstanding advance from the Government of India, and (3) the surplus and reserves of the Corporation.

After the expiry of five years from its incorporation, the Corporation will be required to transfer 25 per cent of its profits every year to a Reserve Fund to meet contingencies and for other purposes conducive to the interests of the

Corporation, until the Reserve Fund is equal to the outstanding Government advance.

(*Source: Reserve Bank of India Bulletin for February, 1955*)

Up to the end of 1960, the Corporation has sanctioned rupee loans and guarantees for Rs. 6·55 crores, loans in foreign currencies for Rs. 12·63 crores, underwriting of shares and debentures for Rs. 9·67 crores and made direct subscription to preference and equity capital for Rs. 2·56 crores.

REFINANCE CORPORATION FOR INDUSTRY LTD.

In terms of the Agricultural Commodities Agreement under P.L. 480 signed by the Government of India and the Government of the U.S.A. in August, 1956, a sum of about Rs. 26 crores was to be earmarked for relending to private enterprises through established banking facilities. It was ultimately decided to channel these funds through a separate corporation. Accordingly, the above Corporation was formed on the 5th June, 1958 to provide refinancing facilities to lending institutions. The Corporation has an authorised capital of Rs. 25 crores, of which, Rs. 12·50 crores have been subscribed by the Reserve Bank, Life Insurance Corporation of India, the State Bank of India and 14 larger scheduled banks. Its paid-up capital amounts to Rs. 2·50 crores. The Corporation is managed by a Board of seven Directors with the Governor of the Reserve Bank as Chairman. Three Directors are elected from amongst the shareholder banks other than the State Bank of India while one of the Deputy Governors of the Reserve Bank, the Chairman of the State Bank of India and the Chairman of the Life Insurance Corporation of India are the remaining three Directors.

From out of the total funds of the Corporation at Rs. 38·50 crores, each participating bank was allocated a quota varying from Rs. 1·25 crores to Rs. 3 crores depending upon the size of its deposits. In the case of the State Bank of India, however, a quota of Rs. 5 crores was allotted. The loans to be eligible for refinance are to mature within three to seven years and the amount of loan to any single borrower must not exceed Rs. 50 lakhs. Loans must be to a medium-sized industry, *i.e.*, a concern whose paid-up capital and reserves are not less than Rs. 5 lakhs and do not exceed Rs. 2·50 crores and made for the purpose of increased production. The

lending institutions are to hold the security for the refinancing facility in trust for the Corporation.

The refinancing facilities have since been extended to 43 banks, 14 State Financial Corporations, Madras Investment Corporation and three State Co-operative Banks without requiring them to become shareholders. As a result, the quota allotted to the shareholders has been abolished. The maturity of loans has also been extended from seven years to ten years and refinancing facilities made available against medium-term loans to small-scale industries provided higher loans are guaranteed under the Credit Guarantee Scheme.

Up to the end of 1960, the Corporation sanctioned applications for 578·00 lakhs and actually disbursed Rs. 226·00 lakhs.

Guarantee Scheme for Advances Granted to Small-scale Industries

In order to encourage banks to make increasing advances to small-scale industries, the Government of India, in consultation with the Reserve Bank of India, evolved a Guarantee Scheme which came into force from July 1, 1960. The Scheme is to operate initially for two years on an experimental basis and its object is to help the enlargement of institutional credit to small-scale industries by affording some protection to the lending institutions against possible losses. The Scheme provides for the sharing of such losses by the lending institutions and the Government of India, and the maximum amount recoverable under the Guarantee Scheme in respect of any one advance is Rs. 1 lakh. The Reserve Bank is to administer the Scheme on behalf of Government and there are selected institutions which will be entitled to the benefit of the Scheme, namely, 48 scheduled banks, 21 State Co-operative Banks, 14 State Financial Corporations, Madras Industrial Investment Corporation Ltd., the State Bank of India and its subsidiaries. Other banks and credit institutions can take advantage of the guarantee facility in respect of advances made by them to small-scale industries provided a selected institution is a participant in such advances to the extent of not less than 25% of the advanced amount. The Scheme has since been extended to 52 districts and applies to advances sanctioned from July 1, 1960. The duration of a guaran-

tee is not to be more than seven years from the date of the first disbursement of the advance. The charge for issuing a guarantee is ¼ per cent per annum on the maximum amount of advance or limit as sanctioned. Up to the 30th June, 1961, 941 guarantees have been issued in respect of advances aggregating Rs. 281·39 lakhs.

Report of the Committee on Finance for the Private Sector

In October, 1953 the Reserve Bank of India appointed a committee under the Chairmanship of Shri A. D. Shroff to examine how increased finance would be made available to the private sector through sources other than those which are under the consideration of the Taxation Enquiry Commission. The Committee was, in particular, asked to examine the possibilities of providing on a larger scale bank finance for development in the private sector. The Committee submitted in its report to the Reserve Bank of India a series of measures for implementation by Government, the Reserve Bank of India, financial institutions, industrialists, etc. Some of the important recommendations are summarised below:

The Committee feels that in the past few years several changes have occurred in the socio-economic climate of this country which tend to discourage and discredit private enterprise. The Committee is of the opinion that unless these inhibiting factors are remedied, mere multiplication or strengthening of agencies supplying finance will not add much to industrial development.

Private investment is being affected adversely by the threat of nationalisation, which persists despite the assurance given by leading members of Government that the statutory powers for nationalisation of undertakings in the private sector will not be used unless compelling reasons arise. The Committee is of the opinion that in respect of large investments in scheduled industries which take time to fructify, it should be possible for Government to give some assurance of immunity from nationalisation, at least for a reasonable period.

A major factor impeding private investment in India today is the imposition of a variety of additional obligations on employers by legislative measures or by Tribunal Awards in regard to pay-

ments to labour employed and conditions of employment. The Committee urges that early steps should be taken to remove the confusions and uncertainties in regard to labour legislations and awards and to ensure that a rise in the rewards of labour does not run ahead of the increase in the productivity of labour.

The Committee feels that in addition to the steps already taken by the Reserve Bank, there are other directions in which the Reserve Bank can give a lead and help commercial banks to undertake their new responsibilities with a greater degree of confidence. The Committee does not think it advisable for the Reserve Bank to finance directly investment in private industries. But it feels that the Reserve Bank can facilitate larger investment by commercial banks and other financial institutions by suitable adjustment in its loaning and rediscounting practices.

On the question of long-term advances by commercial banks to industries, the Committee is of the opinion that in the general interest of the credit structure of the country, it does not appear desirable to encourage a tendency on the part of banks to lean on the Reserve Bank for providing liquidity against such advances which they may make on their own judgement and initiative.

The Committee recommends that banks should endeavour to increase their investments in the shares and debentures of first class industrial concerns, to make larger advances to approved parties against such shares and debentures and subscribe to a greater extent to the shares and bonds of specialised institutions like the Industrial Finance Corporation of India and the State Financial Corporations.

The leading banks in India, in co-operation with insurance companies, should form a consortium or syndicate under the leadership of the Imperial Bank of India (now the State Bank of India) for underwriting or investing in new issues of shares and debentures of industrial companies. To facilitate this, the Imperial Bank of India Act should be suitably amended.

The Committee recommends that the Reserve Bank should treat shares and bonds of the Industrial Finance Corporation of India and State Financial Corporations as on a par with Government securities for advances under Section 17(4) (a) of the Reserve Bank of India Act, on such terms regarding margin, etc., as the Reserve Bank may deem appropriate. In order to ensure the

marketability of these shares, the statutory restrictions on the holdings of such shares should be removed.

Having regard to the peculiar difficulties of the smaller banks, the Committee suggests for the consideration of the Reserve Bank of India whether any of the directive or criteria laid down by the Bank could be suitably relaxed, without prejudice to sound banking principles, in view of the special characteristics of the smaller banks such as their deposit structure, and other local conditions.

Facilities under the Bill Market Scheme should be liberalised.

The Committee feels that on the analogy of the Bill Market Scheme it may be possible to explore ways and means of increasing the resources of banks for the provision of medium-term finance by the Reserve Bank through similar facilities under proper safeguards The Reserve Bank may, therefore, examine such possibilities, including if necessary, suitable amendments to the Reserve Bank of India Act.

The Committee considers that it is of the utmost importance that the existing Remittance Facilities Scheme formulated by the Reserve Bank should be further liberalised. The Reserve Bank should, in consultation with the Government of India, work out a detailed scheme of financial assistance to licensed scheduled banks opening branches in accordance with the expansion programme submitted by the banks and approved by the Reserve Bank.

The Committee recommends that the question of linking indigenous bankers and shroffs directly with the Reserve Bank should be actively pursued by the Bank in consultation with the shroffs.

Meanwhile, the Committee suggests that those shroffs who are doing their business by way of sight hundis should consider the possibility of introducing 90 days hundis where practicable. To encourage the use of usance hundis on a large scale, the Committee recommends that the Government of India should consider the question of further reducing the rates of stamp duty on such hundis.

Pending the direct linking of indigenous bankers with the Reserve Bank, steps should be taken to encourage the rediscounting by the Reserve Bank of the usance bills of indigenous bankers such as the Shikarpuri Shroffs, through scheduled banks. If there are any legal difficulties in the way, the Reserve Bank may take

necessary steps to have the Reserve Bank of India Act suitably amended.

The Committee recommends that commercial banks should consider the rediscounting of bills, drawn by traders and small industrialists and endorsed by shroffs, even in place where the banks do not have their offices, provided that the banks are satisfied regarding the standing of the parties.

To enable insurance companies to invest a large proportion of their funds in industrial shares and debentures, it is recommended that Section 27 of the Insurance Act may be amended so as to require the companies to invest their funds as under: 25 per cent in Government securities, 20 per cent in Government securities or other approved securities and the balance of 55 per cent in other investments specified in Section 27A.

In order to make the Industrial Finance Corporation of India a more useful instrument for the provision of industrial finance, the Committee recommends that where the Corporation is satisfied that the managing agent has a reasonable financial stake in the company to which a loan is granted, and is also regarded as eligible in other ways, the additional guarantee of the managing agent need not be insisted upon.

In order to promote better mobilisation of capital, the Industrial Finance Corporation of India should endeavour to give loans in the form of debentures which can, at suitable times, be gradually placed in the market.

The Committee recommends that the Industrial Finance Corporation of India and the State Financial Corporations should give banks an opportunity to participate in the loans sanctioned by them. The Corporations should also examine the question of guaranteeing the long-term loan advanced by scheduled banks or insurance companies.

The Committee is satisfied that genuine hardship is caused to small industries on account of delay in payments by Governments and Government agencies against goods supplied to them. The Committee, therefore, recommends that the Central and State Governments should explore the possibility of opening letters of credit in favour of suppliers stipulating for payments on the presentation of inspection notes by a duly authorised officer of the indenting department.

The Committee feels that if the registration fee on hypothecation bonds of proprietary firms and partnerships registered with the Registrar of Assurances, which is payable on an ad valorem basis at present could be reduced to Rs. 5, it would facilitate the grant of loans to such concerns by commercial banks.

The Committee recommends that in order to augment the finance available to small industries, a Special Development Corporation for small industries should be constituted immediately. In the setting up of this Corporation, the broad features of which are described in the report, the Reserve Bank of India should take the initiative and work out, in collaboration with the other interests concerned, the actual details of its working.

The Committee feels that the establishment of proper issue houses should be encouraged in order to facilitate the raising of fresh capital through floatations on the capital market.

The Committee is of the opinion that industrial investment can be assisted through the formation of investment trusts and unit trusts. The Committee feels that unit trusts in particular would be eminently suitable to conditions in India and that steps should be taken by both the public and the private sectors to encourage the formation of such institutions.

INDUSTRIAL FINANCE CORPORATION IN U. K.

The problem of providing industries in the U. K. with special facilities for obtaining new capital was given serious consideration in the early thirties. The Macmillan Committee (1930-31) which examined the whole problem of industrial finance reported that there was a gap in the existing arrangements for the provision of credit owing to the absence of financial machinery specifically designed to provide (*i*) business with temporary finance in anticipation of an issue of capital and with medium-term finance in connection with contracts and (*ii*) smaller and medium-sized business with long-term capital, where the amounts involved (say, up to £200,000) would not justify or possibly permit of a public issue. The Committee recommended the creation of a special institution to fill this gap.

This recommendation was not implemented until the abnormal conditions following the termination of World War II lent new

urgency to the problem. In 1945 two Corporations—*viz.*, the Industrial and Commercial Finance Corporation (ICFC) and the Finance Corporation for Industry (FCI) were established along the lines suggested by the Macmillan Committee. The ICFC was designed to meet the gap in medium-term and long-term finance facilities for the smaller and medium-sized industrial and commercial business where the amounts involved were between £5,000 and £200,000. The FCI was established to cover the gap in the field of medium and large-scale finance for big industrial concerns. Both these Corporations are intended to provide finance where normal channels are unsuitable and both are required not to compete with existing sources of capital but to supplement them. They are functioning as ordinary limited companies with no official representation on their Boards and having no recourse to public funds. The management of the ICFC is entrusted to a Board of eight Directors representing the Bank of England and the Clearing and Scottish Banks. The FCI is being managed by eight Directors representing the commercial, financial and industrial interests in the country.

Resources : The authorised share capital of the ICFC is £15 million. It can, in addition, borrow up to a further £30 million. The Shareholders are (*i*) the Bank of England, who have a token participation of £½ million and (*ii*) the London Clearing Banks and the Scottish Banks who took shares in proportion to their deposit liabilities. Loan capital is provided by all the shareholders in the same ratio as their shareholdings. As at the date of the last Balance Sheet (March 31, 1954) the total resources of the Corporation amounted to £29 million of which £7·5 million is share capital and £19·8 million is loan capital.

The Finance Corporation for Industry—the larger of the two institutions—has an authorised capital of £25 million divided into 2,500,000 shares of £10 each. The issued and called-up capital is only £500,000 (*i e.* 2 per cent of the authorised capital) of which 40 per cent is held by insurance companies, 30 per cent by trust companies and 30 per cent by the Bank of England. The Corporation is also empowered to borrow from banks up to four times the amount of its authorised capital ; its total potential resources thus amount to £125 million.

Magnitude of Assistance : At the end of March 1954, the

total loans and advances made by the ICFC amounted to nearly £28 million. An industry-wise analysis of its advances and investments from 1946 to 1954 shows that a large variety of industries have received assistance from the Corporation. Chemicals, electrical engineering, textiles and wholesale and retail distribution have had substantial shares in the total advances. In recent years, advances to food, drink and tobacco, building and scientific instruments industries have been showing an increase. By the end of 1954, medium business had received nearly three-fourths, and small businesses the remainder, of the total amount of assistance given, although the former accounted for only one-third of the total number of approved cases.

The FCI, on its part, has given financial assistance to a wide variety of business such as diesel engines, permanent prefabricated houses, shipping, electrical components, steel, oil and chemicals. At the end of March 1954, the Corporation's total investments and commitments to companies other than steel companies amounted to £41 million. The total loans and participations and forward commitments made by the Corporation showed a steady rise since its inception in 1945 and stood at £77·2 million at the end of March 1954.

Loan Policy : The financial facilities provided by the ICFC have taken a number of different forms according to the merits and special requirements of each case. For example, if money is required to cover the cost of re-equipment or re-conversion and borrowers may be expected to repay the loans out of their profits, fixed loans, either secured or unsecured, are granted. If granting of assistance for this purpose involves some risk, finance is provided through participating preference shares. When the reconstruction or expansion of an undertaking requires capital of a permanent nature, financial facilities are offered through non-redeemable preference shares accompanied possibly by a proportion of ordinary shares. When the balance sheet and prospects of a company, anxious to build a new factory or instal new machinery, do not justify an unsecured loan, but the company requires additional working capital to finance the increased turn-over resulting from the acquisition of fixed assets, the Corporation makes its contribution partly through mortgage on fixed assets and partly through

security for bank loans and are calculated to strengthen the position of the company from the banker's point of view.

An analysis of the financial facilities furnished by the Corporation during the nine years of its operation shows that debentures and secured loans have accounted for the largest proportion of the resources advanced, varying from 34 to 40 per cent of the total. Preference shares have accounted for 27 to 37 per cent. The importance of unsecured loans has been diminishing in recent years: from a peak of 31 per cent as at the end of September, 1947 they were down to 21 per cent at the end of March 1954. Investments in ordinary shares which formed only 3 per cent of the total in 1946 rose to 8 per cent in 1950 and further to about 10 per cent at the end of March, 1954. Broadly speaking, two-fifths of the total assistance have been through subscription to shares of all kinds.

The policy regarding rates of interest charged on loans has been influenced by considerations of national interest. This does not, however, mean that the Corporation ignores the general level of interest rates.

The FCI conducts its business with the national interest in view consistent with proper commercial prudence. A few instances of assistance are given below with a view to indicating the broad consideration of policy in respect of the loans made to industry. For example, the genuine consideration shown to industries of national importance is brought out by the aid to the Petro-Chemicals Ltd. In 1946, the FCI became an important shareholder of this company by taking some £$\frac{1}{2}$ million shares out of a little over £$2\frac{1}{2}$ million ordinary shares issued by the company. At the end of March 1954, the total advances made to it amounted to £$8\frac{1}{2}$ million. It received assistance at a time when little experience was available in this field and when normal sources of finance would consider it a risky proposition. Although some consider that the Corporation's investment in this company is still in the category of 'risk capital', the Chairman of the FCI recently stated that Petro-Chemicals had reached the point where it was producing at a profit, although the profit was not yet adequate to cover the interest on capital expenditure and depreciation.

Mention may also be made of the FCI's loan to the Ultramar Company Ltd, as an instance where the Corporation was prepared to finance even overseas development by a British company. This

company was originally formed to acquire, operate and develop oil concessions ; but now it is a holding company with its chief interests in Venezuelan oil. The sums loaned totalled £2 million secured by a first and specific charge on the company's main asset, a wholly-owned Venezuelan subsidiary. The greater part of the advances made by the FCI to the Ultramar has been repaid.

That the interest charged by the FCI on the loans it grants is consistent with profitability is borne out by its practice of charging during the early stage of any venture, the lowest rate of interest consistent with its own borrowing rate. As a counter-measure, however, this Corporation takes options to acquire shares in the capital of the company concerned so that, if the venture is successful, the Corporation will obtain compensation for the risk undertaken. The success in this regard is best illustrated by the example of Perkins Ltd. whose ordinary shares were introduced in the market in May 1954 and have since shown a steady rise.

Profit or Loss : The financial results of the working of the ICFC showed losses totalling £341,200 during the first four years of its operation. In the subsequent five years, it made profits which enabled the Corporation to declare a maiden dividend of 4 per cent in 1953, and in 1954 the dividend was stepped up to 5 per cent.

No profit was made by the FCI during the initial period mainly because some of the projects financed by it took time before they went into production on a substantial scale. In fact, during the first three years of its operation, it incurred a loss of £28,635. By the end of March 1950, however, the losses sustained in the earlier years were completely wiped off and there was instead a profit of £74,926 (after deduction of interest on loans from banks, expenses, taxes and expenses of operation). Since March 31, 1951, the Corporation has adopted a policy of writing off investments in companies in the development stage, because of the impossibility of assessing the ultimate value of such investments. Any net surplus income accruing at the end of each year is, therefore, applied by the Corporation for this purpose, with the result that it has not shown any profits since March 31, 1951. By the end of March 1954, the Corporation had applied £2·7 million for writing off investments in pursuance of this policy, but it had not

established reserves or written off preliminary expenses, nor had it been able to pay a dividend.

Conclusion : From the foregoing survey, it would thus appear that both the Corporations have functioned usefully in financing British industries by assisting them in finding equity capital either through subscriptions to ordinary and preference shares or through loans carrying an option for conversion into equity capital. By and large, they have played a not too negligible role in bridging the 'Macmillan gap' within the limitations imposed by economic and political circumstances. The total loans and participations of the FCI and the ICFC which amounted to £59 million (£77 million inclusive of forward commitments) and to £28 million, respectively, at the end of March 1954, might appear to be small when compared with total investments in British industry during these years, but their importance in the context of catering to marginal requirements cannot be minimised.

The working of both these Corporations during the past nine years has also served to dispel the apprehensions entertained earlier regarding them. FCI's records bring out the fact that, in many cases, the Corporation's advice that applicants should find finance through normal channels has proved correct. A study of the commitments of the Corporations shows clearly that they have generally intervened only when other financial sources have failed. A good part of the FCI's loans has gone to companies with projects involving heavy capital outlays over a period of years, that is, projects which cannot ordinarily be financed by banks. Thus, out of total loans amounting to £33 million actually made in 1950 by the FCI, as much as £21 million had gone to the steel industry to help in its vast development programme. The FCI's advance of £8½ million to Petro-Chemicals was also made at a time when there was little experience available in this field.

Certain sections of the public viewed with serious misgivings the dangers of both the Corporations working at severe losses since their commitments were related to national interests rather than to profitability. This fear has also been dispelled now, as evidenced by the loans to Petro-Chemicals Ltd. and Perkins Ltd. The FCI generally undertakes risks which the investment market is not always willing to back, and it supplies low-cost capital where national interests so dictate. It is inevitable that in some ventures these

two features will encounter risks high enough to make commercial success extremely difficult. But it is generally agreed that the Corporation is doing well in this difficult task.

It is generally accepted that the FCI's scope to help industry might be somewhat wider than hitherto. So far, the call on the FCI for finance in anticipation of capital issues has not been as great as was expected 'owing to many special factors. Some of the largest industries—*e.g.*, steel—were taken out of the province of private finance as a result of nationalisation. Moreover, a good many of the larger concerns had found themselves at the end of the War with liquid resources which were large enough to finance capital equipment to the extent to which equipment was available for purchase. As these resources become exhausted (and there are signs to this effect), there may be increased need for assistance from the FCI. It is also anticipated that there will be greater scope for the FCI in view of the (now denationalised) steel industry's programme of development and modernisation.

To some extent, the bottleneck in the field of industry in recent years has not been so much the lack of finance as the non-availability of physical resources. This was responsible for the relatively mild advance in demand for capital funds experienced by the ICFC in 1953. In part, it also reflected the willingness of banks to expand advances and the increased activity of the new issue market ; from 1952 onwards, the position in regard to financial capital for industry has eased somewhat, as indicated by the introduction of investment allowances in the 1954 budget, with a view to encouraging industry to step up its scale of investment. Nevertheless, there seems to be still good scope for the ICFC inasmuch as it is prepared to facilitate industrial development through the provision of capital funds and loan capital at favourable rates of interest, tailored appropriately to suit the needs of individual applicants. Although finance for the 'Macmillan gap' is a risky one, since the securities issued by borrowers have no ready market and must be held without hope of disposal when business is bad and the borrowers are comparatively less creditworthy, the ICFC has already done a good deal for filling this gap. It is stated that the upper limit of its lending (£200,000) is a factor handicapping its ability to make profits and that if the Corporation is permitted to compete for a certain amount of business outside the 'Macmillan

gap', it would perhaps be in a better position to take risks within the 'gap' itself. In that case, it is felt that it might be possible for the ICFC to invest a larger proportion of its resources in equities than hitherto.

(*Source : Reserve Bank of India Bulletin for February 1955*).

CHAPTER XI

BANKING LEGISLATION IN INDIA AND PARTITION

THERE is no division of opinion about the necessity for banking regulation in India. The demand for banking control and regulation gathered a momentum, when the Travancore National and Quilon Bank Ltd., suspended payment in 1938. It was then felt that the provisions of the Indian Companies Act were too inadequate for the regulation of banking on sound lines and also that there should be a comprehensive banking legislation, like the Insurance Act, to guide banking in India on lines of safety. The questionable way in which some Indian banks were managed, coupled with the failure of many such banks, reinforced the demand for such a legislation, and accordingly a draft of such legislation was framed in the year 1939, apparently with a view to focussing public opinion. In the said draft it was pointed out by Sir James Taylor, the then Governor of the Reserve Bank of India, that the objective of the proposed legislation was to safeguard the interests of the depositors, who had to pay dearly for the failure of many banking institutions. The said draft was circulated for the purpose of eliciting opinions from different quarters and did not proceed further. In the year 1944 the matter was revived and a new draft was prepared for banking legislation in the light of the opinions received in this regard in the year 1940. But in view of the preoccupation with the last war, the Government did not think it opportune to move the bill at that time. Subsequently, the inflationary conditions in the money market and the continuance of the cheap money policy by the Government led to an excessive increase in bank deposits, absolutely and relatively, which led the Reserve Bank of India to foresee the development of some untoward circumstances just after the conclusion of the war, unless some preparatory measures were taken by the Government to regulate the activities of banks. Moreover, the development of a few undesirable features in war-time banking in India made the

Reserve Bank think that a bank crisis might lie ahead if those unwelcome features are not removed. Accordingly, some of the provisions of the draft legislation were incorporated, by way of additions and amendments, in the Indian Companies (Amendment) Act, 1944, in order to remove some of the undesirable features discernible in the capital structure and management of banking companies after the outbreak of the war. Under Sec. 277 H.H. no banking company shall employ or be managed by a managing agent, or any person whose remuneration or part of whose *remuneration* takes the *form of commission* or a share in the profits of the company, or any person having a contract with the company for its management for a period exceeding five years at any one time. Under Sec. 277I the following restrictions were imposed:—

(*i*) The subscribed capital of a banking company should not be less than half the authorised capital and the paid-up capital not less than half the subscribed capital ;

(*ii*) the capital of the banking company should consist of ordinary shares only and such preference shares as may have been issued before the commencement of the Indian Companies (Amendment) Act, 1944 ; and

(*iii*) the voting rights of all shareholders should be proportionate to the contribution made by the shareholder, whether a preference shareholder or an ordinary shareholder, to the paid-up capital of the company.

These restrictions were however not applicable to banks incorporated before the 15th January, 1937. These provisions coupled with the promulgation of Rule 94A of the Defence of India Rules relating to the control of capital issues restricted the growth of mushroom banking institutions.

Stock was then taken of the operations of banks during the war and on the 16th November, 1944, a Bill was introduced for consolidating and amending the law relating to banking companies. The said Bill having lapsed, a new Bill called the Banking Companies Bill, 1946, based on the Bill of 1944 was next introduced on the 15th March, 1946, and was referred to the Select Committee. In the meantime, in order to regulate the expansion of branch banking which had shown certain undesirable features, such as an undue concentration of banking offices in the larger cities, a mushroom expansion of branches by several small banks involving capitalised

expenditure beyond their resources, payment of higher rates of interest on deposits etc., Government decided that the provision in the Bill relating to the control on the opening of branches should be enacted in advance of a main Bill. The Banking Companies (Restriction of Branches) Act, 1946, was accordingly passed requiring banking companies to obtain the permission of the Reserve Bank before opening new offices or changing the location of existing offices. The report of the Select Committee was published on the 17th February, 1947.

The consideration of the Banking Companies Bill, 1946, as amended by the Select Committee, could not be taken up by the Constituent Assembly (Legislative) on account of a large number of amendments necessitated by the constitutional changes. The old Bill was, therefore, withdrawn and a fresh bill, namely, the Banking Companies Bill, 1948, was introduced in the Legislature in March, 1948. The Bill could not be passed during the budget session of 1948 due to the pressure of legislative business. In order, however, to deal with certain features in the banking situation requiring urgent attention and, in particular, to enable the Reserve Bank to assist banks in difficulties, the Government promulgated an Ordinance, *viz.*, the Banking Companies (Control) Ordinance, 1948, in September, 1948, containing some of the important provisions of the Banking Companies Bill. Later in the year 1948, the Select Committee on the Bill met and its report was presented to the Constituent Assembly (Legislative) by the Hon'ble Finance Minister on the 1st February, 1949. The Bill was passed on the 17th February, 1949 and received the assent of the Governor-General on the 10th March, 1949. The Banking Companies Act came into force on the 16th March, 1949, and the Rules and Forms prescribed thereunder were published by the Government in the Official Gazette on the 26th March, 1949. The Banking Companies Act was further amended in 1950 and with the passing of the Banking Companies (Amendment) Act, 1950, which came into force on the 18th March, 1950, the Act now extends to the whole of India with the exception of the State of Jammu and Kashmir.

One of the major changes effected by the Act in the law previously applicable to banking companies is the definition of the term "banking". The Banking Companies Act defines the term "banking" as "the accepting, for the purpose of lending or

Reserve Bank is also empowered to remove from office certain managerial personnel who have been found by any tribunal or other authority (other than a criminal court) to have contravened the provisions of any law. The Reserve Bank is also empowered to prohibit his taking part in the management of any banking company for a period not exceeding five years.

In India, inadequate capital in the case of a large number of banking companies has been found to be one of the major defects of the banking structure of the country. The Reserve Bank's experience of the working of the banking companies has revealed a tendency on the part of small banking companies to extend the area of their operation by indiscriminately opening branches in the different parts of the country including places like Bombay and Calcutta. To remedy this defect, it became necessary to prescribe minimum capital requirements for banking companies in relation to the territorial range of their operations. Section 11 of the Act accordingly prescribes the minimum capital requirements.

Requirement as to minimum paid-up capital and reserves: (1) Notwithstanding anything contained in section 149 of the Companies Act, 1956, no banking company in existence on the commencement of this Act, shall, after the expiry of three years from such commencement or of such further period not exceeding one year as the Reserve Bank, having regard to the interests of the depositors of the company, may think fit in any particular case to allow, carry on business in any State of India, and no other banking company shall, after the commencement of this Act, commence or carry on business in any State of India, unless it has paid-up capital and reserves of such aggregate value as is hereinafter required by this section.

(2) In the case of a banking company incorporated elsewhere than in a State of India, the aggregate value of its paid-up capital and reserves shall not be less than fifteen lakhs of rupees, and, if it has a place or places of business in the City of Bombay or Calcutta or both, twenty lakhs of rupees:

Provided that no such banking company shall be deemed to have complied with the provisions of this sub-section, unless it deposits and keeps deposited with the Reserve Bank an amount not less than the minimum required by this sub-section, either in

cash or in unencumbered approved securities, or partly in cash and partly in such securities.

(3) In the case of any banking company to which the provisions of sub-section (2) do not apply, the aggregate value of its paid-up capital and reserves shall not be less than—

(*i*) if it has places of business in more than one State, five lakhs of rupees, and if any such place or places of business is or are situated in the City of Bombay or Calcutta or both, ten lakhs of rupees ;

(*ii*) if it has all its places of business in one State none of which is situated in the City of Bombay or Calcutta, one lakh of rupees in respect of its principal place of business, plus ten thousand rupees in respect of each of its other places of business situated in the same district in which it has its principal place of business, plus twenty-five thousand rupees in respect of each place of business situated elsewhere in the State otherwise than in the same district:

Provided that no banking company to which this clause applies shall be required to have paid-up capital and reserves exceeding an aggregate value of five lakhs of rupees:

Provided further that no banking company to which this clause applies and which has only one place of business, shall be required to have paid-up capital and reserves exceeding an aggregate value of fifty thousand rupees ;

(*iii*) if it has all its places of business in one State, one or more of which is or are situated in the City of Bombay or Calcutta, five lakhs of rupees, plus twenty-five thousand rupees in respect of each place of business situated outside the City of Bombay or Calcutta, as the case may be:

Provided that no banking company to which this clause applies shall be required to have paid-up capital and reserves exceeding an aggregate value of ten lakhs of rupees.

Explanation.—For the purposes of this sub-section, a place of business situated in a State other than that in which the principal place of business of the banking company is situated shall, if it is not more than twenty-five miles distant from such principal place

of business, be deemed to be situated within the same province as such principal place of business.

(4) Any amount deposited and kept deposited with the Reserve Bank under sub-section (2) by any banking company incorporated elsewhere than in a State of India shall, in the event of the company ceasing for any reason to carry on banking business in the States of India, be an asset of the company on which the claims of all the creditors of the company in the States of India shall be a first charge.

(5) For the purpose of this section "value" means the real or exchangeable value, and not the normal value which may be shown in the books of the banking company concerned.

(6) If any dispute arises in computing the aggregate value of the paid-up capital and reserves of any banking company, a determination thereof by the Reserve Bank shall be final for the purposes of this section.

Section 12 regulates the relationship between the authorised, subscribed and paid-up capital of banking companies incorporated on or after the 15th January, 1937. No banking company shall carry on business in any State of India, unless it satisfies the following conditions, namely:

(*i*) that the subscribed capital of the company is not less than one-half of the authorised capital, and the paid-up capital is not less than one-half of the subscribed capital and that, if the capital is increased, it complies with the conditions prescribed in this clause within such period not exceeding two years as the Reserve Bank may allow ;

(*ii*) that the capital of the company consists of ordinary shares only or of ordinary shares and such preference shares as may have been issued prior to the 1st day of July, 1944 ;

(*iii*) that, subject to the provisions contained in clause (*iv*) hereof, the voting rights of any one shareholder, whether a preference shareholder or an ordinary shareholder, are strictly proportionate to the contribution made by him to the paid-up capital of the company ;

(*iv*) that the voting rights on poll of any one shareholder do not exceed five per cent of the total voting rights of all the shareholders:

Provided that nothing contained in this section shall

apply to any banking company incorporated before the 15th day of January, 1937.

This provision does not, however, apply to a foreign banking company. Non-compliance with this provision will disentitle a bank to carry on banking business in India.

Section 12A empowers the Reserve Bank to require any banking company to call a general meeting of the shareholders of the company within a specified time to elect, in consonance with the voting rights permissible under the Act, new directors.

Section 13 restricts payment of commission, brokerage, discount or remuneration in any form in respect of any shares issued by it, any amount exceeding in the aggregate two and one-half per cent of the paid-up value of the said shares.

Section 14 prohibits the creation of charge upon the unpaid capital of a banking company. Section 14A prohibits the creation of a floating charge on the assets of a banking company unless it obtains a certificate from the Reserve Bank.

Under Section 15, no banking company is permitted to pay any dividend on its shares until all its capitalised expenses have been completely written off. It is, however, permissible for a bank to declare a dividend without writing off depreciation in the value of investments in approved securities where such depreciation is not capitalised or accounted for as a loss, etc. A banking company may, however, pay dividends on its shares without writing off depreciation, if any, (*i*) in the value of its investments in approved securities, where depreciation has not been capitalised or otherwise accounted for as a loss and (*ii*) in the value of its investments in shares, debentures or bonds if adequate provision has been made to the satisfaction of the auditor of the banking company; (*iii*) adequate provision has been made against bad debts to the satisfaction of the auditor of the banking company.

With a view to preventing interlocking of directorates of banking companies, a provision has been made in section 16 of the Act under which a banking company incorporated in India is prohibited from having as a director any person who is a director of another banking company or of companies which among themselves are entitled to exercise voting rights in excess of twenty per cent of the total voting rights of all the shareholders of the banking company.

Section 17 provides that every banking company incorporated in India shall create a reserve fund and shall out of the balance of profit of each year as disclosed in the profit and loss account prepared under section 29 and before any dividend is declared, transfer a sum equivalent to not less than 20% of such profit to the reserve fund until the amount in the said fund together with the amount in the share premium account is equal to the paid-up capital. Any appropriation from the reserve fund or the share premium account has to be reported to the Reserve Bank within twenty-one days from the date of appropriation explaining the circumstances of such appropriation.

Under section 18, every banking company not being a scheduled bank shall maintain by way of cash reserve in cash with itself, or in an account opened with the Reserve Bank or the State Bank of India or any other bank notified by the Central Government in this behalf, or partly in cash with itself and partly in such account or accounts a sum equivalent to at least two per cent of its time liabilities in India and five per cent of its demand liabilities in India and shall file with the Reserve Bank before the fifteenth day of every month a statement of the amount so held on Friday of each week of the preceding month with particulars of its time and demand liabilities on each Friday. For the purpose of this section and section 24 liabilities in India shall not include the paid-up capital or the reserves or any credit balance in the profit and loss account of the company or any advance taken from the Reserve Bank or the State Bank of India or from the Refinance Corporation for Industry Ltd. or from any notified bank.

Section 19. *Restriction on nature of subsidiary companies.*—(1) A banking company shall not form any subsidiary company except a subsidiary company formed for one or more of the following purposes, namely, the undertaking and executing of trusts, the undertaking of the administration of estates as executor, trustee or otherwise, the providing of safe deposit vaults or, with the previous permission in writing of the Reserve Bank, the carrying on of the business of banking outside India such other purposes as are incidental to the business of banking.

(2) Save as provided in sub-section (1), no banking company shall hold shares in any company, whether as pledgee, mortgagee or absolute owner, of an amount exceeding thirty per cent of the

paid-up share capital of that company or thirty per cent of its own paid-up share capital and reserves, whichever is less:

Provided that any banking company which is on the date of the commencement of this Act holding any shares in contravention of the provisions of this sub-section shall not be liable to any penalty therefor if it reports the matter without delay to the Reserve Bank and if it brings its holding of shares into conformity with the said provisions within such period, not exceeding two years, as the Reserve Bank may think fit to allow.

(3) Save as provided in sub-section (1) and notwithstanding anything contained in sub-section (2), a banking company shall not, after the expiry of one year from the date of the commencement of this Act, hold shares, whether as pledgee, mortgagee or absolute owner, in any company in the management of which the managing director or manager of the banking company is in any manner concerned or interested. It is intended to prevent banking companies from carrying on trading activities by acquiring a controlling interest in non-banking companies. It follows the lines of section 277M of the Indian Companies Act with certain modifications. The subsidiaries formed prior to the commencement of the Act were not affected by section 19.

In many cases the failure of Indian banks in the past was in no small measure due to the practice of granting unsecured advances to the directors or their relations or to firms or private companies in which any of the directors was interested and also against their own shares. With a view, therefore, to protecting the interests of the depositors, section 20(1) of the Act prohibits a banking company from granting (*a*) loans on the security of its own shares, or (*b*) unsecured loans or advances to any of its directors or to firms or private companies in which it or any of its directors is interested as partner or managing agent or to any individuals, firms or private companies in cases where any of its directors is a guarantor. In terms of sub-section (2) of section 20, every banking company is required to submit to the Reserve Bank a monthly return showing all unsecured loans and advances granted by it to companies in which it or any of its directors is interested as director or managing agent or guarantor. If, on an examination of these returns, it appears to the Reserve Bank that any loans or advances of the type referred to above are being

granted to the detriment of the interests of the depositors the Reserve Bank has been empowered in terms of sub-section (3) of section 20 of the Act to prohibit the grant of such further loans and advances or to impose restrictions on the grant thereof or to direct the banking company to secure the repayment of any such loan or advance within a specified period. A scrutiny of the returns carried out by the Reserve Bank revealed that some banking companies had granted disproportionately large unsecured advances to companies in which their directors were interested or that such advances had been outstanding for a considerable period. The Reserve Bank directed the banking companies either to take steps for the repayment of the advances or to obtain adequate security from the companies concerned.

Section 21 of the Act empowers the Reserve Bank to determine the policy in relation to advances to be followed by banking companies generally or by any banking company in particular, where it is satisfied that it is necessary or expedient in the public interest to do so. The Reserve Bank is also authorised to give directions to banking companies, either generally or to any banking company or a group of banking companies in particular, as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances and the rates of interest to be charged on advances.

In terms of section 22, every banking company is required to obtain a licence before commencing banking business in India, while an existing banking company is allowed to carry on banking business until a licence is refused to it. It is further provided that a licence shall not be refused to an existing banking company for a period of three years. Before granting any licence under this section, the Reserve Bank may require to be satisfied, by an inspection of the books of the company or otherwise, that all or any of the following conditions are fulfilled, namely:

(*a*) that the company is in a position to pay its present or future depositors in full as their claims accrue ;

(*b*) that the affairs of the company are not being conducted to the detriment of the interests of its present or future depositors ;

(*c*) in the case of a company incorporated outside India that the Government or law of the country in which it is in-

corporated does not discriminate in any way against banking companies registered in India, and that the company complies with all the provisions of this Act, applicable to banking companies incorporated outside India.

This section does not, however, apply to the State Bank of India and its subsidiaries.

Section 23 of the Act embodies, with slight modifications, the provisions of the Banking Companies (Restriction of Branches) Act, 1946. The modifications effected are two-fold. Firstly, they remove restrictions on the transfer of the location of an existing place of business of a banking company within the same city, town or village and secondly, they enable the banking companies to open temporary offices for a period not exceeding one month, without the permission of the Reserve Bank, for the purpose of affording banking facilities to the public on the occasion of an exhibition, conference or *mela*.

Restrictions on opening of new, and transfer of existing places of business.—No banking company shall open a new place of business or change, otherwise than within the same city, town or village, the location of an existing place of business without obtaining the prior permission in writing of the Reserve Bank ; and before giving any such permission the Reserve Bank may require to be satisfied by an inspection under section 35 or otherwise as to the financial condition and history of the company, the general character of its management, the adequacy of its capital structure and earning prospects and that public interest will be served by the opening, or as the case may be, change of location, of the place of business:

Provided that nothing in this section shall apply to the opening for a period not exceeding one month of a temporary place of business within a city, town or village or the environs thereof within which the banking company already has a place of business for the purpose of affording banking facilities to the public on the occasion of an exhibition, conference or *mela*.

Explanation.—For the purposes of this section "place of business" includes any sub-office, pay-office, sub-pay-office and any place of business at which deposits are received, cheques cashed or moneys lent.

The development of branch banking in India has been lopsided and whereas some areas seem to possess more than adequate bank-

ing facilities, others are undeveloped or under-developed from the point of view of banking. At the same time it will be in the interests of the banking system of the country not to allow unsound banking companies to open places of business even in the undeveloped areas, while permitting a well-managed bank to open an office at a place which is already being served by marginal banks, may assist in the development of sound banking traditions.

Section 24. *Maintenance of a percentage of assets.*—(1) After the expiry of two years from the commencement of this Act, every banking company shall maintain in India in cash, gold or unencumbered approved securities, valued at a price not exceeding the current market price, an amount which shall not at the close of business on any day be less than twenty per cent of the total of its time and demand liabilities in the States of India.

Explanation.—For the purposes of this section, "unencumbered approved securities" of a banking company shall include its approved securities lodged with another institution for an advance or any other credit arrangement to the extent to which such securities have not been drawn against or availed of.

(2) In computing the amount for the purposes of sub-section (1), the deposit required under sub-section (2) of section 11 to be made with the Reserve Bank by a banking company incorporated elsewhere than in a State of India and any balance maintained by a banking company with the Reserve Bank or its agent or with any other bank notified in this behalf by the Central Government, including in the case of a scheduled bank the balance required under section 42 of the Reserve Bank of India Act, 1934 (II of 1934), to be so maintained, shall be deemed to be cash maintained.

(3) For the purpose of ensuring compliance with the provisions of this section, every banking company shall, not later than fifteen days after the end of the month to which it relates, furnish to the Reserve Bank in the prescribed form and manner a monthly return showing particulars of its assets maintained in accordance with the section, and its time and demand liabilities at the close of business on each Friday during the month, or if any Friday is a public holiday under the Negotiable Instruments Act, 1881 (XVI of 1881), at the close of business on the preceding working day.

The failure of the Travancore National and Quilon Bank Ltd.

in 1938 which obtained the bulk of its deposits from the Provinces of India but kept the greater part of its assets outside the Provinces, brought home the necessity of protecting the interests of the depositors in India by requiring banking companies to maintain a reasonable proportion of their liabilities in India in the form of assets in India. To this end, a provision was first made in the Banking Companies (Control) Ordinance, 1948, which required that the assets in the Provinces of India of every banking company as at the close of the last working day of every quarter should not be less than 75% of its demand and time liabilities therein. This provision has been reproduced in section 25 of the Banking Companies Act. For the purposes of this section "assets in India" shall be deemed to include export bills drawn in, and import bills drawn on and payable in India and expressed in such currencies as the Reserve Bank may from time to time approve in this behalf and also such securities as the Reserve Bank may approve in this behalf notwithstanding that all or any of the said bills or securities are held outside India.

Section 26. *Return of unclaimed deposits.*—Every banking company shall, within thirty days after the close of each calendar year, submit a return in the prescribed form and manner to the Reserve Bank as at the end of such calendar year of all accounts in the States of India which have not been operated upon for ten years, giving particulars of the deposits standing to the credit of each such account:

Provided that in the case of money deposited for a fixed period the said term of ten years shall be reckoned from the date of the expiry of such fixed period.

Similar returns are called for in the banking legislation of Canada.

Section 27 provides for the submission of monthly returns by banking companies relating to their assets and liabilities in India and section 28 for the publication of such information in a consolidated form.

Section 29 of the Act provides for the preparation of a balance sheet and profit and loss account in the Forms set out in the Third Schedule or as near thereto as circumstances admit in respect of all business transacted by a banking company in India as on the last working day of the year.

Section 30 provides for the audit of the balance sheet and prescribes how an auditor is required to certify the balance sheet audited.

Section 31 requires the accounts and balance sheet together with the auditor's report to be published in a certain manner and to be submitted in triplicate to the Reserve Bank within three months from the end of the period to which they relate, *i.e.*, by 31st March every year.

Section 32 deals with the cases where balance sheets and accounts of banking companies are to be sent to Registrars.

Section 33 requires foreign banking companies to display their balance sheets till copies of subsequent accounts are available.

Section 35 confers upon the Reserve Bank powers to inspect the books and accounts of banking companies whenever the Reserve Bank thinks such inspections necessary or when the Reserve Bank is so directed by the Central Government. It is obligatory on the Reserve Bank to furnish a copy of the inspection report to the bank concerned under this section. The inspection of banking companies by the Central Banking Authority for the purpose of safeguarding the interests of the depositors is comparatively a recent development in India. The practice of inspection of banking companies on a restricted scale was started by the Reserve Bank in consultation with the Government of India in 1940, when, with the prior consent of banking companies concerned, the Reserve Bank undertook to inspect their books and accounts with a view to determining the real or exchangeable value of their paid-up capital and reserves for the purpose of considering their eligibility for inclusion in the Second Schedule to the Reserve Bank of India Act. The Banking Companies (Inspection) Ordinance, 1945, widened the objective of the inspection and the purpose underlying the inspection was gradually shifted from the quantitative assessment of the real or exchangeable value of the paid-up capital and reserves of a banking company to a qualitative appraisal of its financial position, management and methods of operation. For the adequate discharge of its duties and responsibilities under the Banking Companies Act, the Reserve Bank has decided to institute systematic periodical inspections of all banking companies governed by the Act with a view to helping them in

the establishment of sound banking traditions by drawing their attention to the defects or unsatisfactory working methods at an early stage.

Section 35A empowers the Reserve Bank to issue directions to banking companies in the national interest or to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in any manner prejudicial to the interests of the banking company or to secure the proper management of any banking company generally.

Section 35B requires a banking company to obtain the approval of the Reserve Bank for the amendment of any provision relating to the appointment or re-appointment or remuneration of a managing director or any other director, whole-time or otherwise, or of a manager or a chief executive officer by whatever name called. The appointment or re-appointment of a managing or whole-time director or a chief executive officer also requires the previous approval of the Reserve Bank.

Section 36. *Further powers and functions of Reserve Bank.*—(1) The Reserve Bank may—

(*a*) caution or prohibit banking companies generally or any banking company in particular against entering into any particular transaction or class of transactions, and generally give advice to any banking company ;

(*b*) on a request by the companies concerned and subject to the provisions of section 45, assist, as intermediary or otherwise, in proposals for the amalgamation of such banking companies ;

(*c*) give assistance to any banking company by means of the grant of a loan or advance to it under clause (3) of sub-section (1) of section 18 of the Reserve Bank of India Act, 1934 (II of 1934) ;

(*d*) during the course, or after the completion, of any inspection of a banking company under section 35, by order in writing,

(*i*) require the banking company to call a meeting of its directors for the purpose of considering any matter in the course of or out of such inspection or of meeting an officer of the Reserve Bank to discuss any such matter ;

(ii) depute one or more of its officers to watch the proceedings at any meeting of the Board of Directors of the banking company or of any committee or other body constituted by it and require the banking company to give an opportunity to the officers so deputed to be heard at such meetings and also require such officers to send a report of such proceedings to the Reserve Bank ;

(iii) require the Board of Directors of the banking company or any committee or any other body constituted by it to give in writing to any officer specified by the Reserve Bank in this behalf at his usual address all notices of, and other communications relating to, any meeting of the Board, committee or other body constituted by it ;

(iv) appoint one or more of its officers to observe the manner in which the affairs of the banking company or of its offices or branches are being conducted and make a report thereon ;

(v) require the banking company to make, within such time as may be specified in the order, such changes in the management as the Reserve Bank may consider necessary in consequence of the state of affairs disclosed during or by the inspection.

In terms of the provisions of Section 36A certain provisions of the Act are made inapplicable to banking companies which have been refused a licence under section 22 or whose licence has been cancelled, or which have been prohibited from accepting fresh deposits by a compromise, arrangement or scheme sanctioned by a court or by any order made in any proceeding relating to such compromise, arrangement or scheme or prohibited from accepting deposits by virtue of any alteration in its memorandum.

Experience of bank liquidations had shown that the provisions of the Indian Companies Act in respect of liquidations were unsuitable and inadequate in the case of banking companies. Part III of the Banking Companies Act, therefore, lays down special provisions relating to suspension of business and winding

up of banking companies, the more important of which are enumerated below:

(*i*) The total period of moratorium has been limited to six months (section 37).

(*ii*) Provision has been made for the winding up by the High Court if a banking company is unable to pay its debts or on an application made by the Reserve Bank for the purpose. The circumstances in which the Reserve Bank may make an application for the winding up of a banking company and also the circumstances in which a banking company may be deemed to be unable to pay its debts have been specified (Section 38).

(*iii*) The Central Government has been empowered to appoint a court liquidator to be attached to every High Court for the purpose of conducting all proceedings for the winding up of banking companies (Section 38A).

(*iv*) On an application being made by the Reserve Bank for the winding up of a banking company, the Reserve Bank, the State Bank of India or any other bank notified by the Central Government on this behalf shall be appointed as the official liquidator (Section 39).

(*v*) The provisions of the Companies Act, 1956 relating to a liquidator have been made applicable to a liquidator of a banking company (Section 39A).

(*vi*) The power of the Court to stay proceedings has been restricted to cases in which it is satisfied that the depositors can be paid in full as their claims accrue (Section 40).

(*vii*) The period prescribed under section 455 of the Companies Act 1956 for the submission of a preliminary report by the official liquidator has been reduced to two months (Section 41).

(*viii*) After the preferential payments referred to in section 530 of the Companies Act, 1956 have been made or adequate provision to the satisfaction of the High Court has been made, there shall be paid to every depositor in the savings bank account, a sum of one hundred rupees or the balance at his credit, whichever is less, in priority to all other debts from out of the remaining assets of the banking company available for payment of general creditors (Section 43A).

(*ix*) Further, it has been provided that no banking company may be voluntarily wound up unless the Reserve Bank certifies in writing that the banking company is able to pay in full all its debts to its creditors as they accrue. The circumstances in which the High Court is empowered to order winding up and where banking company is being wound up voluntarily have also been specified (Section 44).

(*x*) The procedure for amalgamation of banking companies has been laid down in section 44A. The provisions of this section are as follows:

Section 44A. *Procedure for amalgamation of banking companies.*—(1) Notwithstanding anything contained in any law for the time being in force, no banking company shall be amalgamated with another banking company, unless a scheme containing the terms of such amalgamation has been placed in draft before the shareholders of each of the banking companies concerned separately, and approved by a resolution passed by a majority in number representing two-thirds in value of the shareholders of each of the said companies, present either in person or by proxy at a meeting called for the purpose.

(2) Notice of every such meeting as is referred to in sub-section (1) shall be given to every shareholder of each of the banking companies concerned in accordance with the relevant articles of association, indicating the time, place and object of the meeting, and shall also be published at least once a week for three consecutive weeks in not less than two newspapers which circulate in the locality of localities where the registered offices of the banking companies concerned are situated, one of such newspapers being in a language commonly understood in the locality or localities.

(3) Any shareholder, who has voted against the scheme of amalgamation at the meeting or has given notice in writing at or prior to the meeting to the company concerned or to the presiding officer of the meeting that he dissents from the scheme of amalgamation, shall be entitled, in the event of the scheme being sanctioned by the Reserve Bank, to claim from the banking company concerned, in respect of the shares held by him in that company, their value as determined by the Reserve Bank when sanctioning the scheme and such determination by the Reserve Bank as to the

value of the shares to be paid to the dissenting shareholder shall be final for all purposes.

(4) If the scheme of amalgamation is approved by the requisite majority of shareholders in accordance with the provisions of this section, it shall be submitted to the Reserve Bank for sanction and shall, if sanctioned by the Reserve Bank by an order in writing passed in this behalf, be binding on the banking companies concerned and also on all the shareholders thereof.

(5) Where a scheme of amalgamation is sanctioned by the Reserve Bank under the provisions of this section, the Reserve Bank shall transmit a copy of the order sanctioning the scheme to the Registrar with whom the banking companies concerned have been registered, and the Registrar shall, on receipt of any such order, strike off the name of the company (hereinafter in this section referred to as the amalgamated banking company) which by reason of the amalgamation will cease to function.

(6) On the sanctioning of a scheme of amalgamation by the Reserve Bank, the property of the amalgamated banking company shall, by virtue of the order of sanction, be transferred to and vest in, and the liabilities of the said company shall, by virtue of the said order, be transferred to and become the liabilities of the banking company which under the scheme of amalgamation is to acquire the business of the amalgamated banking company, subject in all cases to the terms of the order sanctioning the scheme.

Apart from compliance with the formality prescribed in this section, the main consideration which weighs with the Reserve Bank in sanctioning a scheme of amalgamation is whether the interests of depositors of the amalgamating units will be promoted by the amalgamation.

According to Section 44B, no Court shall sanction a compromise or arrangement between a banking company and its creditors or any class of them or between such company and its members or any class of them unless the compromise or arrangement is certified by the Reserve Bank as not being detrimental to the interests of the depositors of such company. For the purpose of issuing a certificate under this section, the main considerations which weigh with the Reserve Bank as pointed out in Bank's annual report, are whether the management could be relied upon to work the scheme in the best interests of the depositors of the banking

company and whether with the existing realisable assets, the scheme is likely to be implemented. Whenever the Reserve Bank feels that the chances of serving the interests of the depositors of a banking company are greater under a scheme of amalgamation than under liquidation, a certificate is issued under this section.

Section 45. *Power of Reserve Bank to apply to Central Government for suspension of business by a banking company and to prepare scheme of reconstitution or amalgamation.*—(1) Notwithstanding anything contained in the foregoing provisions of this Part or in any other law or any agreement or other instrument for the time being in force, where it appears to the Reserve Bank that there is good reason so to do, the Reserve Bank may apply to the Central Government for an order of moratorium in respect of a banking company.

(2) The Central Government, after considering the application made by the Reserve Bank under sub-section (1), may make an order of moratorium staying the commencement or continuance of all actions and proceedings against the company for a fixed period of time on such terms and conditions as it thinks fit and proper and may from time to time extend the period so however that the total period of moratorium shall not exceed six months.

(3) Except as otherwise provided by any directions given by the Central Government in the order made by it under sub-section (2) or at any time thereafter, the banking company shall not during the period of moratorium make any payment to any depositors or discharge any liabilities or obligations to any other creditors.

(4) During the period of moratorium, if the Reserve Bank is satisfied that—

(*a*) in the public interest ; or

(*b*) in the interests of the depositors ; or

(*c*) in order to secure the proper management of the banking company ; or

(*d*) in the interests of the banking system of the country as a whole,—

it is necessary so to do, the Reserve Bank may prepare a scheme—

(*i*) for the reconstruction of the banking company, or

(*ii*) for the amalgamation of the banking company with

any other banking institution (in this section referred to as "the transferee bank").

(5) The scheme aforesaid may contain provisions for all or any of the following matters, namely:

(*a*) the constitution, name and registered office, the capital, assets, powers, rights, interests, authorities and privileges, the liabilities, duties and obligations, of the banking company on its reconstruction or, as the case may be, of the transferee bank ;

(*b*) in the case of amalgamation of the banking company, the transfer to the transferee bank of the business, properties, assets and liabilities of the banking company on such terms and conditions as may be specified in the scheme ;

(*c*) any change in the Board of Directors, or the appointment of a new Board of Directors, of the banking company on its reconstruction or, as the case may be, of the transferee bank and the authority by whom, the manner in which, and the other terms and conditions on which, such change or appointment shall be made and in the case of appointment of a new Board of Directors or of any director, the period for which such appointment shall be made ;

(*d*) the alteration of the memorandum and articles of association of the banking company on its reconstruction or, as the case may be, of the transferee bank for the purpose of altering the capital thereof or for such other purposes as may be necessary to give effect to the reconstruction or amalgamation ;

(*e*) subject to the provisions of the scheme, the continuation by or against the banking company on its reconstruction or, as the case may be, the transferee bank, of any actions or proceedings pending against the banking company immediately before the date of the order of moratorium ;

(*f*) the reduction of the interest or rights which the members, depositors and other creditors have in or against the banking company before its reconstruction or amalgamation to such extent as the Reserve Bank considers necessary in the public interest or in the interests of the members, depositors and other creditors or for the maintenance of the business of the banking company ;

(*g*) the payment in cash or otherwise to depositors and other creditors in full satisfaction of their claim—

(*i*) in respect of their interest or rights in or against the banking company before its reconstruction or amalgamation ; or

(*ii*) where their interest or rights aforesaid in or against the banking company has or have been reduced under clause (*f*), in respect of such interest or rights as so reduced ;

(*h*) the allotment to the members of the banking company for shares held by them therein before its reconstruction or amalgamation [whether their interest in such shares has been reduced under clause (*f*) or not], of shares in the banking company on its reconstruction or, as the case may be, in the transferee bank and where any members claim payment in cash and not allotment of shares, or where it is not possible to allot shares to any members, the payment in cash to those members in full satisfaction of their claim—

(*i*) in respect of their interest in shares in the banking company before its reconstruction or amalgamation ; or

(*ii*) where such interest has been reduced under clause (*f*), in respect of their interest in shares as so reduced ;

(*i*) the continuance of the services of all the employees of the banking company [excepting such of them as not being workmen within the meaning of the Industrial Disputes Act, 1947 (14 of 1947) are specifically mentioned in the scheme] in the banking company itself on its reconstruction or, as the case may be, in the transferee bank at the same remuneration and on the same terms and conditions of service, which they were getting or, as the case may be, by which they were being governed, immediately before the date of the order of moratorium:

Provided that the scheme shall contain a provision that—

(*i*) the banking company shall pay or grant not later than the expiry of the period of three years from the date on which the scheme is sanctioned by the Central

Government, to the said employees the same remuneration and the same terms and conditions of service as are applicable to employees of corresponding rank or status of a comparable banking company to be determined for this purpose by the Reserve Bank (whose determination in this respect shall be final) ;

(*ii*) the transferee bank shall pay or grant not later than the expiry of the aforesaid period of three years, to the said employees the same remuneration and the same terms and conditions of service as are applicable to the other employees of corresponding rank or status of the transferee bank subject to the qualifications and experience of the said employees being the same as or equivalent to those of such other employees of the transferee bank:

Provided further that if in any case under clause (*ii*) of the first proviso any doubt or difference arises as to whether the qualifications and experience of any of the said employees are the same as or equivalent to the qualifications and experience of the other employees of corresponding rank or status of the transferee bank, the doubt or difference shall be referred to the Reserve Bank whose decision thereon shall be final ;

(*j*) notwithstanding anything contained in clause (*i*) where any of the employees of the banking company not being workmen within the meaning of the Industrial Disputes Act, 1947 (14 of 1947) are specifically mentioned in the scheme under clause (*i*), or where any employees of the banking company have by notice in writing given to the banking company or, as the case may be, the transferee bank at any time before the expiry of one month next following the date on which the scheme is sanctioned by the Central Government, intimated their intention of not becoming employees of the banking company on its reconstruction or, as the case may be, of the transferee bank, the payment to such employees of compensation, if any, to which they are entitled under the Industrial Disputes Act, 1947 (14 of 1947) and such pension, gratuity, provi-

dent fund and other retirement benefits ordinarily admissible to them under the rules or authorisations of the banking company immediately before the date of the order of moratorium ;

(*k*) any other terms and conditions for the reconstruction or amalgamation of the banking company ;

(*l*) such incidental, consequential and supplemental matters as are necessary to secure that the reconstruction or amalgamation shall be fully and effectively carried out.

(6) (*a*) A copy of the scheme prepared by the Reserve Bank shall be sent in draft to the banking company and also to the transferee bank and any other banking company concerned in the amalgamation, for suggestions and objections, if any, within such period as the Reserve Bank may specify for this purpose ;

(*b*) the Reserve Bank may make such modifications, if any, in the draft scheme as it may consider necessary in the light of the suggestions and objections received from the banking company and also from the transferee bank, and any other banking company concerned in the amalgamation and from any members, depositors or other creditors of each of those companies and the transferee bank.

(7) The scheme shall thereafter be placed before the Central Government for its sanction and the Central Government may sanction the scheme without any modifications or with such modifications as it may consider necessary ; and the scheme as sanctioned by the Central Government shall come into force on such date as the Central Government may specify in this behalf:

Provided that different dates may be specified for different provisions of the scheme.

(8) On and from the date of the coming into operation of the scheme or any provision thereof, the scheme or such provision shall be binding on the banking company or, as the case may be, on the transferee bank and any other banking company concerned in the amalgamation and also on all the members, depositors and other creditors and employees of each of those companies and of the transferee bank, and on any other person having any right or liability in relation to any of those companies or the transferee bank.

(9) On and from such date as may be specified by the Central

Government in this behalf, the properties and assets of the banking company shall, by virtue of and to the extent provided in the scheme, stand transferred to, and vest in, and the liabilities of the banking company shall, by virtue of and to the extent provided in the scheme, stand transferred to, and become the liabilities of, the transferee bank.

(10) If any difficulty arises in giving effect to the provisions of the scheme, the Central Government may by order do anything not inconsistent with such provisions which appears to it necessary or expedient for the purpose of removing the difficulty.

(11) Copies of the scheme or of any order made under sub-section (10) shall be laid before both Houses of Parliament, as soon as may be, after the scheme has been sanctioned by the Central Government, or, as the case may be, the order has been made.

(12) Where the scheme is a scheme for amalgamation of the banking company, any business acquired by the transferee bank under the scheme or under any provision thereof shall, after the coming into operation of the scheme or such provision, be carried on by the transferee bank in accordance with the law governing the transferee bank, subject to such modifications in that law or such exemptions of the transferee bank from the operation of any provisions thereof as the Central Government on the recommendation of the Reserve Bank may, by notification in the Official Gazette, make for the purpose of giving full effect to the scheme:

Provided that no such modification or exemption shall be made so as to have effect for a period of more than seven years from the date of the acquisition of such business.

(13) Nothing in this section shall be deemed to prevent the amalgamation with a banking institution by a single scheme of several banking companies in respect of each of which an order of moratorium has been made under this section.

(14) The provisions of this section and of any scheme made under it shall have effect notwithstanding anything to the contrary contained in any other provisions of this Act or in any other law or any agreement, award or other instrument for the time being in force.

(15) In this section, "banking institution" means any banking company and includes the State Bank of India or any other

banking institution notified by the Central Government under section 51.

Sections 45A-45X contain special provisions for speedy disposal of winding up proceedings. The Government of West Bengal appointed a committee in March, 1949, to examine the working of the provisions of the Indian Companies Act with a view to devising means whereby effective steps could be taken to conduct the liquidation proceedings of banks in the interest of creditors and public morality and to institute effective criminal proceedings against officers of banks and other persons where necessary. In the light of the findings of this Committee, the Central Government in consultation with the Reserve Bank promulgated on the 19th September, 1949, the Banking Companies (Amendment) Ordinance, 1949, which contained certain amendments to the Banking Companies Act. The provisions of this Ordinance have been incorporated in the Banking Companies (Amendment) Act 1950 with certain modifications.

In 1952 the Government of India appointed a Committee, *viz.*, Banks' Liquidation Proceedings Committee, to examine the various issues connected with the speedy disposal of liquidation proceedings of banking companies. The recommendations of the said Committee were incorporated in the Banking Companies (Amendment) Ordinance, 1953 which was later replaced by an Act of Parliament. The various provisions of the amended Act of 1953 (incorporated in general as Part IIIA of the Banking Companies Act) have been framed with a view to expediting the pace of liquidation proceedings. The Act has laid down a specified period of limitation in respect of claims by a banking company, a simpler procedure for settlement of list of debtors and obtaining of decrees in respect of the outstanding debts of a banking company in liquidation as well as a summary procedure for the enforcement of decrees by providing that any amount found due to the banking company by an order of the High Court may be recovered in the same manner as arrear of land revenue. The Act has also provided that the High Court should have the sole jurisdiction over matters related to winding up proceedings of banking companies so that references to a multiplicity of courts may be avoided. It has also made provision for the expeditious enforcement of the liability of the directors and assessment of damages and devised a simpler procedure of

providing entries in the books of account of the banking companies and also provided for the appointment by the Central Government of Court Liquidators in High Courts. For the present Court Liquidators have been appointed in the High Courts of Bombay, Calcutta and Kerala. The Banks' Liquidation Proceedings Committee had also made certain recommendations for economising the cost of liquidation, such as, exemption from court fees and stamp duty of applications, suits and other proceedings related to the winding up of banking companies. The Reserve Bank of India has been empowered under the Act to call for returns and information from the liquidators of banking companies and also to inspect the books of account of a banking company which is being wound up at the instance of the Central Government. The Act has also made special provisions for punishing offences in relation to banking companies being wound up. The Reserve Bank of India has also been authorised to tender advice in winding up proceedings when so directed by the High Court.

PARTITION AND BANKING

Since the partition of India into two Dominions, namely Pakistan and Indian Union, as from the 15th August, 1947, repercussions of this painful division were visible in the banking sphere as well. Banks operating in the East and West Punjab suffered enormous losses consequent upon the wholesale destruction resulting from the communal riots following in the wake of division. Reliable statistics are not available as to the extent of losses, but there is little doubt that the losses must be heavy due to the destruction of the assets of the banks. On the basis of figures relating to the offices of scheduled banks before partition, it appears that the number of offices of Indian banks in Pakistan, including the Muslim banks, is 410 and the offices of Exchange Banks number 19. Of the 410 offices of Indian banks, West Punjab accounts for 251, North-West Frontier Province for 25, Baluchistan for 7, Sind for 5 and East Bengal for 122. An idea can be formed about the distribution of demand and time liabilities, cash-balances and of advances in the two dominions from the table given hereafter.

In the case of almost all the items, the proportion of India and Pakistan is uniformly about 9 : 1. This ratio makes an interesting

reading in the context of the recent financial agreement between Pakistan and India, in terms of which the public debts and cash-balances of the Government of India before partition have been distributed between the two Governments at a much higher ratio of 18%.

(Value in lakhs of rupees)

	Demand Liabilities		Time Liabilities		Cash Balance		Advance	
	Indian Union	Pakistan	Indian Union	Pakistan	Indian Union	Pakistan		
Week ended 1947								
August 22	625·02	65·47	304·33	39·46	36·08	5·09	359·47	43·64
Percentage to total	(91)	(9)	(89)	(11)	(88)	(12)	(89)	(11)
September 26	634·19	64·78	307·92	30·23	35·40	4·40	355·08	43·27
Percentage to total	(91)	(9)	(89)	(11)	(89)	(11)	(89)	(11)
October 31	650·56	70·04	313 14	31·12	36·55	4·37	370 92	35·92
Percentage to total	(90)	(10)	(91)	(9)	(89)	(11)	(91)	(9)
November 28	654·42	77·48	311·36	30·90	35·51	4·82	364·61	38·58
Percentage to total	(89)	(11)	(91)	(9)	(89)	(11)	(90)	(10)
December 5	656·28	78·34	312·39	30·25	36·40	4·06	365·06	38·83
Percentage to total	(89)	(11)	(91)	(9)	(90)	(10)	(90)	(10)

It will be interesting to observe that banking business is the monopoly of the non-Muslims both in India and Pakistan. It is to be watched how the banking business fares in Pakistan in future. The Prime Minister of Eastern Pakistan in his public utterances has assured the Indian banks full protection and participation in trade and commerce of that Dominion. Moreover, he states that if foreign banks can operate in Pakistan, what difficulty should there be in the way of the functioning of the Indian banks. Pakistan, for its proper development, will require the services of the banks and it is expected that the Pakistan Government should not mete out any discriminatory treatment to the Indian banks. Shri C. D. Deshmukh, ex-Governor of the Reserve Bank of India, has strongly pleaded for the fostering of the economic unity between the two countries in spite of the political division. Despite the political division, efforts must not be spared to continue to the fullest extent possible, by mutual agreement, the economic unity of India. India and Pakistan, political limbs of what will always remain a geographic and economic unit, can hardly afford to forget what the world is discovering after painful experience that prosperity, like peace, is indivisible. In our opinion that purpose can

be well-served through the medium of banks which will act as vital links between the two countries, if they are allowed to function in both the countries without let or hindrance.

The Government of India took prompt steps to localise the crisis among the Punjab banks by agreeing to extend financial assistance to those banking institutions which were in need thereof. The second measure, which was equally useful, was the promulgation of an Ordinance entitled the East Punjab and Delhi Banking Ordinance, which provided powers for the grant of moratorium to banks seeking help under it. The Government has earmarked a sum of Rs. 1 crore for the rehabilitation of the affected banks. During the period of abeyance of civil proceedings, the banks were authorised to make payment to depositors not exceeding 10% of current account at each bank in India or Rs. 250, whichever is less; while moratorium was in force, the bank was prohibited from receiving fresh deposits. The Pakistan Government too passed a parallel Ordinance. Such a prompt measure on the part of the Government of India prevented the spread of adverse repercussions of this shock into other parts of the country and the panicky situation in the banking sphere was thus wonderfully brought under way. The Pakistan Government promulgated an Ordinance in West Punjab prohibiting any transfer of time and demand deposits, and assets of the bank outside that region without the permission of the Government, which had at last to be withdrawn under protest from the Government of India, as it was in violation of the Standstill Agreement. Such a move has generated in the banking circle a hesitant tendency and a sense of uncertainty about the future of banking in Pakistan. In Pakistan another Ordinance has been issued prohibiting banks from giving effect to such orders of another Government or Head Office of the bank functioning in Pakistan, preventing payments to Pakistan nationals. Any bank acting contrary to such Ordinance will be subject to penalty, as also freezing of its assets, if any. The Pakistan Government has alleged that the banks have refused to pay cheques or hand over securities and other things held in their custody to Pakistan nationals under instructions from their Head Office situated outside Pakistan, the instructions being based on orders issued by a Government other than the Government of Pakistan. The Ordinance has been issued to enable the Govern-

ment to handle the situation which has so arisen, and to afford speedy relief to the nationals of Pakistan, who are suffering as the result of the orders of another Government. Under the Ordinance No. 5 of 1947, the Pakistan Government is empowered to investigate into the complaints of the above nature against banks conducting business in Pakistan. "Where the Government is satisfied that this is the case, payment or delivery by a bank may be ordered by the Government, and in the event of non-compliance by the bank the Government may seize and release the assets of the bank sufficient to discharge the banks' liability to the customers concerned." The section of the Ordinance further states that no bank can stop payment of a cheque without the prior approval in writing of an officer appointed by the Central Government of Pakistan in this behalf.

Agreements Arrived at between India and Pakistan

As a result of discussions between the representatives of the Governments of India, Pakistan, West Punjab and East Punjab, and of the Reserve Bank and other banks, the following arrangements have been made to facilitate resumption of business by banks which have closed their offices owing to disturbances or which find themselves unable to carry on their normal functions owing to paucity of staff. The Punjab Government have agreed to make all the necessary arrangements for the protection and housing of non-Muslim staff of banks in Lahore, and also to provide guards at bank premises in Lahore at the expense of the banks. Arrangements have also been made for the training of Muslim candidates in Lahore for recruitment to banks' services. Banks should, therefore, arrange to get back as many of their staff to Lahore as possible and supplement it, where possible, with locally recruited staff. If on account of staff or other difficulties, banks are unable to carry on business except at one branch at Lahore or a limited number of branches at a few centres, they will be allowed, if they so desire, to close the remaining branches and to remove their business to such of their offices as are functioning after giving due notice of such removal to their local constituents through newspapers or otherwise. On being satisfied that such notice has been given, the Custodian of Evacuee Property will give them necessary

permission to remove all their valuables, cash, securities, accounts, records etc. to the branches at which the business is to be consolidated. On obtaining such permission they should approach Mr. Habib-ur-Rahman, Under-Secretary, Finance, West Punjab Government, who will make the necessary arrangements with the Deputy Commissioner of the districts to assist them in the removal.

Transfer of Accounts.—There are many complaints by evacuees in both dominions about cheques and matured fixed deposit receipts being returned by banks with frivolous objections and about applications for transfer of accounts being refused on similar flimsy grounds, such as non-return of unused cheques. In order to avoid inconvenience and distress to the evacuee depositors and in their own interests, banks are requested to desist from such practices and to co-operate by giving all possible facilities to their constituents. To the extent these difficulties in regard to the transfer of accounts from one dominion to the other are due to the non-functioning of banks and the difficulties of communication, these will largely disappear when the business of banks is consolidated and some of their branches start functioning properly and when communications improve. To facilitate transfers it is suggested that each bank should designate one office in India and one in Pakistan for clearing claims for the inter-dominion transfer of accounts. The names of these offices, which should be properly manned for handling this business, should be announced in the press so that constituents may refer their applications for transfer and any complaints in this regard to these offices.

No Restrictions on Transfer.—In this connection it may be mentioned that both the dominions have agreed not to place any restrictions on transfer of accounts or remittance of funds by banks in connection with such transfers. Only in the case of accounts of companies which continue to function in Pakistan, the Pakistan Government have stipulated that their previous permission should be obtained.

Registration of Claims—The West and the East Punjab Governments have issued Evacuees (Administration of Property) Ordinances under which all the property of evacuees is vested in a custodian and other Provincial Governments concerned are taking similar actions. When banks have any claims, whether in regard to their own property or the property of their debtors pledged,

hypothecated, assigned or otherwise charged as security for loans advanced by them, they should take early steps to register their claims with the Custodian of Evacuees Property of the province in which the property is situated.

Survey of Financial Position.—The West Punjab Government have also agreed to give facilities to banks in making a survey of their financial position. For this purpose, it is necessary that, where possible, the banks should depute their staff to tour selected areas after obtaining the necessary help from Mr. Habib-Ur-Rahman. The Reserve Bank staff at Lahore will also assist them in making an appraisement of their financial position.

These arrangements will go a long way towards enabling banks to resume their normal working. They will be, however, of no avail unless the banks themselves take the initiative in this matter and make a determined effort to secure their staff, re-open their branches and start functioning. It is only if they try to help themselves by such efforts that they would be able to overcome their present difficulties. No improvement can take place if they do nothing. It is earnestly hoped that in their own interest and that of their creditors banks will lose no time in taking actions on the lines indicated above.

An Inter-Dominion Agreement on Banking was entered into on the 23rd April, 1949. It was agreed that the two Governments should nominate two representatives from each side to watch the implementation of the decisions taken. Another Indo-Pakistan Agreement on Movable Property of Evacuees was entered into between the representatives of the two Governments on the 28th June, 1950. It was agreed that no ratification of the decisions arrived at was necessary and that action might be taken by both Governments in accordance with those decisions. Subsequently, the Governments of India and Pakistan have arrived at certain conclusions/decisions at the Indo-Pakistan Conferences at Karachi held in March-April, 1955 for implementing the aforesaid Agreement. In terms of these conclusions/decisions, a procedure has been evolved for the bulk release of articles belonging to evacuees kept in lockers, or left in the custody of banks for safe deposit.

During the period 1956-61, the Indian banks have been facing a number of difficulties in Pakistan. The Custodian of Evacuee Property, Lahore declared a number of banks as evacuees thereby

denying them the facilities under the Banking Agreement and the Agreed Decision thereon, particularly relating to the realisation of their assets. Orders were also served on most of the Indian banks whereby they were not permitted to operate on their bank accounts in Pakistan without the express permission of the Custodian of Evacuee Property, Lahore. The above issues were discussed in a series of meetings of the Implementation Committees under the Banking and Movable Property Agreements in 1960-61 and the result was that in September 1961 Pakistan issued a notification exempting 59 Indian displaced banks from the operation of the Evacuee Property law and declared them as non-evacuees. In December 1961, a notification defreezing the assets of evacuee Indian banks was also issued by the Pakistan Authorities. The exchange of evacuee lockers, safe deposits and bank accounts took place on the 30th November 1961. Satisfactory progress has also been made in regard to the transfer of sale proceeds of movable property, payment of compensation for the assets of joint stock companies etc. Most of the outstanding problems have thus been resolved.

PART III

PRACTICAL BANKING

CHAPTER XII

BANKER AND CUSTOMER

THERE has been as yet no agreed definition of banking or of a banker. Under section 3 of the Indian Negotiable Instruments Act, 1881, the term "Banker" includes persons, or a corporation, or a company, acting as "Bankers" but the section has not clearly defined who is a banker. Even the English law could not give an acceptable definition of the term "Banking" or "Banker." Each definition, so far attempted, emphasised certain functions of banks, but was not so far complete by itself.

Dr. Hart, the author of "Law of Banking", defines a banker as "One who, in the ordinary course of his business, *honours cheques* drawn upon him by persons for whom he receives money on *current accounts*." Thus, according to him, the use of cheque facilities in current accounts constitutes the distinguishing feature of a "Bank". Sir John Paget also points out the characteristic features of banking as the acceptance of deposit accounts, current accounts, the issuing and paying of cheques and collection of cheques, crossed and uncrossed, for customers.

In India the term "Banking" had no statutory definition until the passing of the Indian Companies Act, 1936 (since repealed). Under section 277F of that Act, a banking company is defined as "a company which carries on as its principal business the accepting of deposits of money on current account or otherwise, subject to withdrawal by cheque, draft or order," notwithstanding its engaging in certain forms of business enumerated therein. But that definition too did not include any such companies, which otherwise received deposits but did not offer any cheque facilities. So to remove this difficulty a further amendment was moved in October, 1942, as an addition to the aforesaid section wherein it was stated that "any company which used as part of the name under which it carries on business the word 'Bank', 'Banker', or 'Banking' shall be deemed to be a banking company, notwithstanding that the accepting of deposits of money on current

account or otherwise, subject to withdrawal by cheque, draft or order, is not, or is not shown to be, the principal business of the company." In the Indian Banking Companies Draft Bill, 1946, banking was defined as the accepting of deposits repayable on demand and a banking company meant any company which might be wound up under the Indian Companies Act, 1913, and which transacted the business of banking in India. But the Select Committee being not satisfied with this definition, suggested an amended definition of banking as the accepting, for the purpose of lending and investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise. This definition was finally incorporated in section 5(1) (b) of the Banking Companies Act, 1949.

Who is a Customer.—The decided cases show that a customer should be such a person as has "some sort of an account, either deposit or current account or some similar relation" with a banker. Casual transactions like encashment of cheques from a banker without having any account will not entitle any one to be called a customer of that bank (G. W. Railway *vs.* London and County Bank, 1901).

According to Sir John Paget, two conditions should be satisfied before a person can be called a customer. *Firstly*, there must be some recognisable course or habit of dealing. A single transaction will not, according to this view, make one a customer unless there is some continuity. Duration is a determining factor in this regard. *Secondly*, transactions should be in the nature of regular banking business unlike casual transactions.

But in the case of Commissioners of Taxation *vs.* English, Scottish and Australian Bank Ltd., it has been decided that duration is not of the essence in the relationship of a "Customer". Even a single transaction may constitute a customer.

The position of a "Customer", when summed up, comes to this that the opening of an account is the principal criterion of a customer ; time factor is of no consideration. Casual transactions like encashment of cheques or deposit of valuables for safe custody with the bank without any account will not make any one a customer of the bank.

"The relation of banker and customer is primarily that of debtor and creditor" (Sir John Paget). When money is received

by a banker from a customer, the money ceases to be the money of the principal, *i.e.*, the customer, but becomes the absolute property of the banker with the obligation of the latter to honour the cheques drawn by the customer, provided there is sufficient balance available for the purpose. Thus a banker does not hold the money in a fiduciary capacity.

The relation of debtor and creditor between a banker and customer does not give a complete picture. The debt due by a banker as referred to above, differs from an ordinary commercial debt in the sense that demand is necessary in the case of the former, but as a rule demand has nothing to do with a commercial debt. In the case of a bank-debt demand must have to be made. The bank is not bound to pay unless it is called upon to make the payment. By an amendment of Art. 60 of the Indian Limitation Act, 1908, demand has been made an express condition for the recovery of any debt due from a banker.

Ordinarily, a banker is not the depository or trustee of a customer, except in cases of deposits of securities or valuables with the former for safe custody, as in these cases the properties belong to the customers and not to the banker.

A bank may act as an agent of its customer only when it undertakes to buy or sell securities, collect cheques and other instruments, serve as a trustee, executor, attorney or correspondent, on behalf of the latter.

SPECIAL FEATURES OF RELATIONSHIP

1. Obligation to honour cheques if the customer's balance is sufficient and cheques are presented within a reasonable time after the ostensible dates of issue. According to practice, cheques must have to be presented within six months from the date of issue, failing which the cheques become ante-dated and hence "stale". This statutory obligation on the part of a banker to honour his customer's cheques, may be extended by an agreement, express or implied, to the amount of overdraft agreed upon.

   Consequences of Wrongful Dishonour.—If a customer's cheque is, without justification, dishonoured by a banker, he incurs the liability of compensating the custo-

mer for injury to the customer's credit. Thus a customer can claim a substantial damage from a banker if he can prove that his credit has suffered; even if he sustains no pecuniary loss. It does not follow that the compensation will be large only if the cheque so dishonoured involves a large sum. Even if the cheque involves a small amount, compensation may be claimed for a larger sum for wrongful dishonour of such a cheque, as credit is more damaged by return of a cheque for a small amount than for a large one. In assessing the damage to credit, the courts give due consideration to various factors, like financial position, business reputation of the customer, custom of the trade in which he is engaged, etc.

Payment of Domiciled Bills.—A banker is not bound to honour bills accepted by his customer and made payable at the domicile of the banker, if there is no arrangement with the banker in this regard. No liability attaches to the banker in such a case.

2. *Banker's General Lien.*—The right to retain goods is known as "lien". Bankers has a general lien on all securities deposited with them as bankers by a customer, unless there be an express contract, or circumstances that show an implied contract, inconsistent with lien (Brandao *vs.* Barnett). The banker's general lien confers upon him the right to retain securities in respect of the general balance due by the owner to the banker. It extends to all funds and securities coming into the hands of the banker, which are not specifically appropriated. Thus lien cannot be exercised on money, deposited by a customer for purchase of T/T (Telegraphic Transfers) and the like, or on securities placed with the banker for safe custody, even if the customer remains indebted to the bank. Where bonds are deposited with a banker, who is authorized to cut off coupons and collect them, the lien attaches to the bonds as well as the coupons, because they come into the possession of the banker as a collecting agent ; but if the bonds are deposited for safe custody and the customer cuts off the coupons and hands them to the bank for collection, the lien is enforceable on the coupons but not on the

bonds. Similarly, no lien will attach to securities left with the banker through mistake or inadvertence, nor to valuables deposited for some specific purposes. Lien will not arise upon the credit balance of a partner as against the money due to the bank by the partnership firm and *vice versa* because of this reason that credit and liability do not exist in such a case in the same rights. But where the partners undertake responsibility for the firm jointly and severally, lien will exist on the credit balance of a partner's private account against a debit balance of the firm's account but not *vice versa*. Likewise, lien will not attach to a trust account, nor will it arise in respect of an amount which has not till then become due. The right to lien does not become barred by limitation but remains in continuous existence.

The general lien of a banker is more than an ordinary lien ; it is an "implied pledge". As such, the ordinary remedies of a pledgee would appear to apply where appropriate to the character of such securities, to securities held under the lien. But the banker should give reasonable notice of his intention to exercise his power of sale. No agreement is necessary to create the right of lien, as such an agreement is already implied in section 171 of the Indian Contract Act, so long as it is not expressly excluded. The Indian law, besides permitting the banker to exercise his lien in the case of all those securities which come into his possession in the course of his dealings as a banker with his customer, also extends the right to goods, unless there is a contract, express or implied, inconsistent with the lien. Thus cheques, bills, etc. sent to a banker for collection, may fall within the scope of a banker's general lien, even though those instruments may belong to the customer of the correspondent.

General and Particular Lien.—Where specific securities, say to the value of Rs. 50,000, are pledged to cover an advance of Rs. 40,000 plus interest, it is a case of particular lien. In default on the part of the customer, the advance may be squared up by the disposal of the securities valued at Rs. 50,000 but the surplus of Rs. 10,000

cannot be appropriated for any other debt owed by the customer to the banker. Here the particular lien defeats the general lien. But if the securities are allowed to remain with the banker even after the specific loan is paid up, the banker will acquire a general lien. If a specific pledge cannot be proved under section 171 of the Indian Contract Act, 1872, a general lien will apply.

Examples

Probably subject to general lien.	Probably not subject to general lien.
Bills or cheques deposited for collection, or pending discount.	Securities received for sale.
Warrants for dividends paid to the banker under mandates.	Securities deposited upon a particular trust, although the trust fails.
Bearer bonds, if the banker cuts off the coupons and collects them.	Bearer bonds if the customer calls and cuts off the coupons himself. Securities left in the banker's hand after an advance against them has been declined.
Securities deposited to secure a specific loan, but left in the banker's hands after the loan has been repaid (Re London and Globe Finance Corporation).	Securities deposited to secure a specific loan (Cuthbert *vs.* Roberts, Lublock & Co.).

3. *Banker's Right to Combine Accounts.*—There is a conflict of views as the right of a banker to combine the accounts of a customer against his general indebtedness to the banker, when accounts have been opened separately.

Some are of the opinion that such a right to combine accounts is exercisable by a banker and some opine that such a right cannot be exercised without the customer's prior consent, as the customer's credit may suffer if his cheques, drawn on his credit balance, are dishonoured because of its combination with the general debt account. In order to steer clear of such conflicting views, it is always advisable for a bank to take a general letter of set-off from his customer, who opens more than one account in the same capacity and right, so that debits and credits in his different accounts may be adjusted without any trouble or notice to the customer. But it is to be understood that such a right to combine accounts, even if conferred by the general letter of set-off, will apply to existing debts only but not to future debts. In order to claim a set-off, the debts must be between the same parties in the same right. No right of set-off exists between joint accounts and the separate accounts and the separate accounts of the joint-holders, *i.e., no set-off is permissible on the credit balance of a private account against the debit balance of a joint account.* The banker can combine two accounts at different branches, whereas a customer, in the absence of a special agreement to the contrary, cannot exercise this right.

Set-off

The general principle is that, apart from express agreement, there is no right of set-off between joint and separate debts, even in bankruptcy. Thus (*a*) A's credit balance cannot be set off against the joint debt of A & B unless

(*i*) he has expressly agreed that it may, or

(*ii*) A & B have agreed to be both jointly and severally responsible for the debt in their joint names.

(*b*) The joint credit balance cannot be set off against a debt in either of the sole names unless both A & B have agreed with the bank that it may.

Apart from express agreement, the bank has no right to set off a partner's private account against an overdraft

on partnership account. If, however, the partners have undertaken to be severally as well as jointly responsible to the bank for the partnership liabilities, the bank may set off their credit balances against such liabilities. Similarly, the money held by a person in a fiduciary capacity, cannot be set off against his private debt. The banker has the right to set off the balance in a person's deposit account against the latter's indebtedness. But a deposit balance cannot be set off against the depositor's contingent liability on current discounted bills. If a depositor, who has also an overdrawn current account, assigns his debt to another person and notice of the assignment is given to the bank, the bank can, as against the assignee, set off the overdraft against the deposit. As regards the right of set-off in respect of a guarantor's credit balance as against his liability under the guarantee, it may be stated that if the guarantee is payable on demand, no debt is owing by the guarantor to the bank until demand is made, and accordingly until then there can be no right of set-off. As soon as demand has been made the right to set off is exercisable.

4. *Secrecy of the Customer's Account.*—A banker is bound to the secrecy of his customer's account. He is under an obligation not to disclose the balance or the position of his customer's account to any outsider, lest the latter's credit may be affected by such a disclosure. Such an obligation rested on a banker as a matter of practice but was later on given a legal recognition in the *Tournier case*. In that case it is held that a banker must not disclose the condition of his customer's account except on *reasonable* and proper occasions and this obligation will not end even with the closing of the customer's account.

But in the following circumstances disclosure is justifiable:—

(*a*) In cases where the customer has given his banker as a reference, the latter will be fully justified in answering all the trade references invited by the customer.

(*b*) When he is compelled to disclose the state of an account by an order of a Court.

(*c*) A banker will not make himself liable for any slander or libel if he divulges the state of his customer's account when he is under a public duty to disclose it, *i.e.*, in case of danger or treason to the State.

(*d*) When the protection of the banker's own interests legally requires it (*i.e.*, in an action against the customer for money due), he will not make himself liable by disclosing the state of his customer's account.

(*e*) When an inquiry is received from a fellow banker about the credit, means and integrity of his customer, the banker is, as a matter of custom, justified in transmitting to the latter such information in general terms, as can be gleaned from a study of his customer's account. The report should be given in a non-committal manner without being biased by bazar rumours about the party's credit. When an outsider who is not a banker asks for information or opinion about a party without the latter's authority, the bank should decline to give it and send a reply to this effect that the bank will have no objection to give the opinion, if authorised by the customer to do so.

5. *Incidental Charges.*—It has become a practice with the bank to realise incidental charges from customers yearly or half-yearly having regard to the volume of transactions passed, activities shown in the ledgers and miscellaneous work involved in the keeping of the customer's accounts. Besides these charges are levied for any shortfall in the minimum balances to be kept, by agreement, in the customer's accounts.

6. *Laws of Limitation and Deposits.*—The current deposits of a customer with the bank do not become time-barred, even if those deposits are not withdrawn, nor any interest accrued thereon drawn by the customer, nor, any acknowledgment given of those debts by the bank, within three years (Joachimson *vs.* The Swiss Bank Corporation). In the case of a credit balance on current account, the statute does not begin to run until demand has been made and not complied with.

But with regard to the applicability of the law of limitation to fixed deposits with the bank, there is a division of opinion. According to some, time will begin to run, in respect of fixed deposits, from the date of demand being made on the bank. But others hold that if the customer has given a notice to withdraw the money after a specified period, time will run after the expiry of the specified period, and not from the date of the giving of the notice. The latter view seems to be acceptable. But if the return of the fixed deposit receipt is made a condition precedent to withdrawal, according to the rules of the bank, time will begin to run only from the date of the return of the said fixed deposit receipt. Sir John Paget remarks that banks are not in the habit of setting up the statute against any legal claim.

7. The obligation imposed on a banker in the matter of payment and collection of cheques on account of his customers.

CHEQUE

A cheque is an order on a banker to pay money. It has been defined by section 6 of the Negotiable Instruments Act, 1881, as "a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand". A cheque is to fulfil the following three conditions, *viz.*, that (1) it should answer the definition of a bill of exchange which is defined by section 5 of the Negotiable Instruments Act, 1881, as "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument", (2) it should be drawn on a banker, and that (3) it should be payable on demand. A cheque is thus an unconditional order in writing drawn on a banker signed by the drawer, requiring the banker to pay on demand a sum certain in money to or to the order of specified person or to bearer, and which does not order any act to be done in addition to the payment of the money. In the ultimate analysis the following conditions should be fulfilled, if any instrument is to be called a cheque:—

1. The order to the bank must be unconditional in the sense

that no other condition, like the completion of a prescribed receipt-form by the payee, should attach to the payment of the cheque. But if such an order is issued to the payee and not to the bank, the latter should accept such an order as unconditional.

2. The instrument must be in *writing ;* writing may be done by means of printed characters, a type-writer and pen or pencil. As writing in pencil is subject to unauthorised alterations, which become too difficult to detect, such writing should always be discouraged and the cheque should be returned to the drawer for confirmation.

   Writing of cheques with Reynolds International Pens and other pens of the same type had become the subject of discussion among bankers of different countries. The matter was raised in our country and referred to other countries like England, the U.S.A. for their views on such writing. The consensus of opinion is that there are no legal grounds on which use of ball-pointed pens could be banned. The Federal Reserve Bank of New York gave a similar opinion. According to them, it would be impossible to enforce a requirement that cheques and other negotiable instruments which have been signed by the use of ball-point type pens, would not be accepted. So they do not contemplate interference with the use of ball-point type pens. But they maintain that if any signature or writing should come to them in indistinct form, whether that writing be made by the use of the "ink" from ball-point type pens or ink from an ordinary type pen, they shall take up the matter with the bank or person from whom the cheques or negotiable instruments are received.

3. The order must be issued to a banker. The instruments drawn on the Government, Treasury, etc. will not be called cheques But drafts drawn by one office of a bank upon its another office are now treated as cheques for all practical purposes, though the drawer and the drawee are the same persons.

4. The order must be for the payment of a certain sum of money. The amount is written on the body of the cheque in words as well as in figures. If the two differ, the

cheque is returnable on the ground "words and figures differ". Similarly, if a cheque is drawn in words but not in figures, the cheque may be returned with the remark "amount in figures required". But some are of opinion that the cheque in such a case is not incomplete though unusual in form and should, therefore, be paid. It is, however, customary for bankers to refuse payment of cheques, the amount of which is expressed in figures. If a cheque drawn for Rs. 50, otherwise in order, bears the words "under Rs. 25" made with a perforating stamp, the banker should return the cheque for explanation or he might incur liability.

5. *It must be payable to or to the order of a specified person or bearer.* Cheques drawn in favour or fictitious persons or imaginary persons should be considered as payable to bearer.
6. The sum must be payable on demand.

Dating.—A cheque should be properly dated if it is to be honoured. If a cheque bears no date and is presented to the bank, the cheque is returnable with the remark "should bear the date". But the holder of such a cheque may insert the date, before he presents it for payment. If a cheque is drawn like November 1, 19—, it may be returned with the answer "Date incomplete". If a cheque dated 1st November bears at the foot the following: "This cheque must be presented for payment on or before December 15" the banker would be justified in refusing payment if the cheque were presented after December 15. Such a clause will not make the cheque a conditional order. If a cheque is post-dated, a banker is not justifiable in debiting his customer's account before the ostensible date of payment and the cheque should be returned, if presented, with the remark "Post-dated—should be presented on the date mentioned on the cheque". But it should be remembered that a cheque does not become invalid by reason of its being post-dated. The bank will undergo a great risk if it pays the cheque before the ostensible date of payment, for it may be prevented from debiting it to the customer's account, if the latter dies, or becomes insolvent or imbecile before the actual date mentioned on the cheque. Sometimes some banks are found marking such post-dated cheques as good for payment, but such

a practice is irregular and illegal as has been decided in the case of Bank of Baroda Ltd. *vs.* Punjab National Bank Ltd.

But if a cheque is dated 31st June, it may be paid on or after 30th June.

A cheque is considered to be stale six months after the date of its issue and such a cheque is returned marked "out of date". It may, however, be paid if confirmed by the drawer. Such is the practice with a bank, though not legally sanctioned, as the liability of the drawer will not cease within three years from the date of its issue in our country.

Payee.—If a cheque is not payable to bearer, the payee must be named. If a cheque is drawn as "Pay...order", it is equivalent to payment to the drawer's order, for which the endorsement of the drawer will be required on the back of the cheque. In case a cheque is drawn as "Pay...or order" it should be returned with the remark "Payee's name required". But a cheque drawn like "Pay...or bearer" may be construed as a "bearer" cheque and hence paid. Sometimes cheques are drawn like "Pay X ..or (with 'or' struck off) bearer", when the paying bank is in doubt as to whether it should be considered as a bearer cheque or whether he is to satisfy himself about the identification of the payee X, who is alone entitled to receive payment. In our opinion, while the dictum "once a bearer, always a bearer" has passed into law and is sought to give a liberal interpretation to the term "bearer", such a cheque should be considered as a bearer cheque and not as an "order" cheque requiring the endorsement or identification of the payee X.

If a cheque is drawn as "Pay X only" after striking off the words "bearer" or "order", it becomes incapable of being transferred, as the word "only" prevents its negotiability to others But if it is issued like "Pay...X" after striking off the words "bearer" or "order", it does not lose negotiability but is recognised as an order cheque, after the passing of the Negotiable Instruments (Amendment) Act, 1919, capable of being further negotiated.

Material Alterations.—Whenever a cheque is altered, that must have to be confirmed by the full signature of the drawer. Material alterations include all those of the date, crossing, place of payment, amount, and name of the payee. If there are two or more signatories, all must join in attesting the alterations, if any. Any

material alterations made without the drawer's attestation render the cheque void. A bearer cheque may be altered into an "order" cheque without attestation by the drawer, but an order cheque can be altered into a "bearer" cheque only when attested by the full signature of the drawer. For confirmation of material alterations, full signature of the drawer should be insisted upon. If a cheque crossed "not negotiable", when presented for payment, has the words "not negotiable" struck through, the alteration is material and the cheque must not be paid without the drawer's confirmation.

Mutilation.—A cheque torn should not be paid unless certified by the drawer and should be returned under reason "mutilated cheque". But mutilated cheques are often paid on the collecting bank's guarantee.

Signatures.—A specimen of the drawer's signature under which his cheque is to be honoured by the banker is supplied to the banker beforehand and the customer should sign the cheque in accordance with his specimen of signature lying with the bank. But if the drawer's signature is forged or unauthorised, however clever the forgery, the banker cannot debit his customer's account in case he pays. If forgery is cleverly perpetrated in such a manner that the bank cannot detect the forgery in the signature of the drawer in spite of normal attention and are being applied, the bank cannot be charged with negligence (London & Riverplate Bank *vs.* the Bank of Liverpool).

In the case of illiterate drawers, the practice is to sign by mark or thumb-impression, in the presence of at least one witness who must be known to the banker and who must not be a member of the bank's own staff. In view of this difficulty the bank does not usually at present open any account in the name of an illiterate person.

If the drawer becomes too ill to sign a cheque, he may have his mark witnessed by a medical attendant and one witness certifying that the drawer was fully conscious at the time of marking his cheque.

Signatures in pencil or rubber stamp should not be accepted by the bank.

In the present circumstances, growing use is being made of chemicals by unscrupulous persons to erase the entire body of the cheque and write therein the amount and figure according as

they like to defraud the bank. So the bank should take all possible care to examine the body of the cheque to find out whether there has been any tampering with the cheque.

The banker must examine his customer's cheque carefully before he charges the amount to the account. The following points should be examined by the banker before paying the customer's cheque:

(*a*) Does the cheque bear a signature which the banker has been instructed to honour, and if so, is the signature genuine?
(*b*) Is the cheque post-dated or stale?
(*c*) Is there any alteration on the cheque?
(*d*) If the cheque is drawn payable to order is it properly endorsed?
(*e*) Is there any notice stopping payment of the cheque or notice intimating the death, bankruptcy or the insanity of the drawer?
(*f*) Is there any notice of defect in the title of the person presenting the cheque?
(*g*) Is there a sufficient sum at the disposal of the customer's account?

When he has satisfied himself on the foregoing points the banker is entitled to debit the cheque to his customer's account.

Dividend Warrants.—Dividend warrants represent the instruments issued by joint-stock companies to the shareholders in payment of the dividends, declared out of the profits of the companies. These are being issued in the form of cheques and can be crossed or negotiated like ordinary cheques. If a dividend warrant is payable to two or more persons, the signature of one of them is, by custom, accepted. No delegation, either "per pro" or otherwise, by an individual is permitted. If, however, the shareholder has signed a mandate for the payment of dividends to a bank, the usual "per pro" signature on behalf of the bank is admissible.

Interest Warrants.—Interest warrants are issued periodically to holders of Consols, Government Loans, Bonds, etc. for interest which has fallen due and which becomes payable at the Central Bank of the country. These interest warrants are not cheques and should have to be endorsed by all the payees before payment can be made.

Postal Orders.—Postal orders are not cheques, since these are drawn by one post office upon the other, which is not a bank. Postal orders can be crossed, in which case a bank can collect the proceeds. The collection of such postal orders is risky on the part of a bank, as under postal regulations the post office can return such postal orders, if found irregular, and can deduct the amount of the postal orders, if paid with irregularity, from any sum payable to the collecting bank and there is no time limit to such deductions. In such a case the bank can recover the amount from the customer if he is solvent but will be devoid of the means of recovery if he is poor and has no capacity to pay.

Lost Cheques.—When a cheque is sent through post without any express authority from the payee, and is lost in transit, the responsibility falls on the sender. But if it is sent at the latter's request, responsibility then lies not with the sender but with the payee. Of course, the sender should take normal precaution in sending such cheques by post, as for example, he should not send an uncrossed bearer cheque by ordinary post. In case a cheque is lost in transit, the drawer should at once stop payment of such cheque under notice to the bank.

Crossing of Cheques.—The effect of the crossing of a cheque is to make payment thereof only to a banker and not to another person. Crossing is of two kinds, *viz.*, general crossing and special crossing. General crossing is defined by section 123 of the Negotiable Instruments Act, 1881, as follows:

> 'Where a cheque bears across its face an addition of the words "and company" or any abbreviation thereof, between two parallel transverse lines, or of two paralleled transverse lines simply, either with or without the words "Not negotiable", that addition shall be deemed a crossing and the cheque shall be deemed to be crossed generally.'

The specimen forms of general crossing are given below:

1

2

& Co

3

Not negotiable

4

Account Payee

Special crossing is defined by section 124 of the Negotiable Instruments Act, 1881, given below:

> 'Where a cheque bears across its face an addition of the name of a banker, either with or without the words "Not negotiable", that addition shall be deemed to be crossed specially, and to be crossed to that banker.'

Where a cheque is crossed specially, the banker on whom it is drawn shall not pay it otherwise than to the banker to whom it is crossed, his agent, for collection. Specimens of special crossing are given below:

1

State Bank of India

2

State Bank of India

3

Not negotiable
State Bank of India

4

A/c payee
State Bank of India

Sometimes a customer obtains from his banker order cheque forms already crossed and issues some of them with the words "Pay cash", followed by his signature added under the crossing. In such cases it is a rule to pay these cheques only to the drawer or his known agent. No opening of cheques should be recognised unless the full signature of the drawer be appended to the altera-

tion, and then only when presented for payment by the drawer or by his known agent.

"Not Negotiable" Crossing.—The above form of "crossing" is often confused by the public. It does not mean that the cheque is not negotiable or transferable. The fact is that the cheque is still negotiable or transferable by endorsement. The only restrictive interpretation of this crossing is that a person taking a cheque crossed generally or specially to himself shall not have, and shall not be capable of giving a better title to the cheque than that which the person from whom he took it had. Suppose if a cheque bearing "not negotiable" crossing is a stolen one and is endorsed in favour of the third party, the latter must receive it subject to this condition that he will have to return the money covered by the cheque to the genuine payee. Some bank employees are found sometimes returning wrongly such cheques with the remark "Not negotiable". It should be remembered that such a crossing does not make the cheque non-transferable but deprives it of the special feature of negotiability. As Tannan aptly remarks, "such a cheque is like a stolen fountain pen or a watch, the transferee of which does not get a better title than that of the thief".

Who can cross a Cheque.—The drawer of a cheque can cross it, if he so desires. Where a cheque is uncrossed (*i.e.* open), the holder may cross it generally or specially. Where a cheque is crossed generally, the holder may cross it specially. Where a cheque is crossed specially, the banker to whom it is crossed may again cross it specially to another bank, his agent, for collection.

Cheques Marked Account Payee.—According to law such a crossing is a direction to the collecting bank, and the paying banker has no obligation in this regard provided the endorsement is in order. The collecting banker is to see that the proceeds of the cheque go to the account of the payee. In case such a cheque is collected for some one other than the payee, the collecting bank is responsible for conversion and is bound to make good the loss the payee suffers on account of such conversion. An uncrossed cheque marked "A/c. payee" and presented across the counter for payment should not be paid. A cheque payable to bearer but marked "Account payee" is to be treated as a bearer cheque and shall not require endorsement on the back. But a practice has developed, in recent years, quite different from the established

law. The above matter was referred to the Council of the Indian Institute of Bankers whereupon they gave the following opinion:

1. The paying banker is under no obligation to obtain a certificate to the effect that the payee's account has been credited.
2. The onus is on the collecting banker who must take steps to credit the amount of the cheque to the payee's account.
3. If the cheque bears any endorsement other than that of the payee there is still no obligation on the paying banker to obtain a certificate, but he may regard himself as being put on enquiry and may, therefore, return the cheque asking for a certificate to the effect that the cheque has been credited to the payee's account.

These words, *i.e.*, "Account payee" are not covered by any section of the Negotiable Instruments Act. We are not aware of any court case in India where this point has arisen. Such words, *i.e.*, "Account payee", as decided in London, are directions to the collecting bank. Sir John Paget remarks that the question has never been settled whether the paying banker can absolutely or with impunity ignore the words "A/c payee" or the like, where endorsements on the cheque show obviously that it is not being collected for the account indicated. So far no case has been made against a paying banker but it is not outside the bounds of possibility that the collecting bank may, when the claim comes forward, have suspended payment and the party who suffered loss may look round for another party against whom he can make the claim. It is a point that may well be argued in support that a banker who pays a cheque crossed by his customer "A/c payee" when it bears evidence of having been negotiated otherwise than to the account of the payee has not obeyed the mandate of his customer and cannot claim to have paid the cheque in due course and in the circumstances the Council would hardly be justified in expressing the view that in no case whatsoever do the words "A/c payee" not concern the paying banker. The words "A/c payee" are to be found on the crossed cheques made payable to order or bearer. The words "A/c payee" are a direction to bankers collecting payment that the proceeds when collected are to be applied to the credit of the account of the payee designated on the face of the cheque. In House Property Co. of London Ltd.

vs. London County and Westminster Bank, it was considered as negligence to collect a cheque payable to a named payee or bearer for an account other than that of the named payee. The fact that a cheque is payable to a specified person or to bearer and crossed "A/c payee" does not minimise the significance of the words.

Duties of a paying banker.—The duties of a paying banker as regards crossed cheques have been laid down in the following sections of the Negotiable Instruments Act:

Sec. 126: Where a cheque is crossed generally, the banker on whom it is drawn shall not pay it otherwise than to a banker.

Sec. 127: Where a cheque is crossed specially to more than one banker, except when crossed to an agent for the purpose of collection, the banker on whom it is drawn shall refuse payment thereof.

Sec. 129: Any banker paying a cheque crossed generally otherwise than to a banker, or a cheque crossed specially otherwise than to the banker to whom the same is crossed, or his agent for collection, being a banker, shall be liable to the true owner of the cheque for any loss he may sustain owing to the cheque having been so paid.

This shows that the bank cannot act contrary to the directions conveyed by the different forms of crossings. If any contravention of the directions takes place, the bank is answerable for the loss sustained by the parties concerned. *Firstly,* the drawer's account cannot be debited. *Secondly,* the bank will lose protection under section 129 of the Negotiable Instruments Act. *Thirdly,* the banker will have to compensate for the loss incurred by the true owner of the cheque.

Protection to a Collecting Banker.—A collecting banker may obtain protection under section 131 of the Negotiable Instruments Act, 1881, which runs as follows:

> "A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment".

Under a new section 131A of the Negotiable Instruments Act, the same protection has been afforded in respect of collection of bank drafts, which can now be crossed like cheques.

If the crossing of a cheque is sought to be opened, the drawer must certify under his full signature "crossing cancelled". A banker should be on his guard when requested to cash a cheque where the crossing has been cancelled, lest by doing so he should render himself liable to the true owner who took the cheque in a crossed condition. On the whole, a banker must not collect any crossed cheque for a person who is not his customer, as by such collection he will lose protection under section 131. Again, protection cannot be obtained if the bank does not undertake to collect the cheque for his customer but is a holder of he cheque for value.

Marking of Cheques as Good for Payment.—Bankers are occasionally requested by the drawer of a cheque to mark or certify it as good for payment for the amount, as for example, when the customer desires to settle any purchase of property or to pay customs duties etc. If a cheque is so marked at the drawer's request, a note should be kept thereof in his account-folio so that the banker may charge the amount to the customer's account. In such a case the drawer of the cheque will have no right to countermand payment. Sir John Paget observes that the effect of a banker's marking of cheques at the instance of the customer is to show that the cheque has been drawn in good faith, that there are funds sufficient and available to meet it and that the credit of the bank has been added to that of the drawer. But in view of the risk involved in such marking, the banks are gradually developing an aversion to this practice. The Calcutta Clearing Banks' Association discontinued the practice of such marking from March, 1945, taking the lesson from the Privy Council's decision in Punjab National Bank Ltd. *vs.* Bank of Baroda Ltd., wherein it was held that the marking of any post-dated cheque was beyond the competence of a bank and so invalid. It was a promise on the part of the certifying bank that the certified amount would be earmarked for payment on the particular day provided sufficient fund is available for the purpose. If fund is not available, the promise to pay will naturally fail. From a broader standpoint such marking should be avoided for all practical purposes. By a resolution in 1920, the committee of London Clearing Bankers

strongly recommended the discontinuance of marking or certifying cheques at customer's request. In lieu of such marking it is safe to provide the banker's draft or payment order.

Marking between Customers and Constructive Payment.—Such marking is often made as a matter of practice between banks for clearing purposes. This custom is in vogue with London clearing banks which mark such cheques as good for the purpose of clearance by which they become bound to another. This is equivalent to constructive payment.

Marking for Holder.—Sometimes banks are requested to mark cheques as good for payment at the instance of the holder. This is not so much prevalent in England but is common in America. But here the risk is that after marking the bank may be notified by the drawer to note stop-payment instructions with regard to that cheque when the bank has already given an undertaking to honour it.

ENDORSEMENTS, PAYMENTS AND COLLECTION OF CHEQUES

Under section 15 of the Indian Negotiable Instruments Act, an endorsement is defined: "When the maker or holder of a negotiable instrument signs the same otherwise than as such maker, for the purpose of negotiation, on the *back* or *face thereof*, or on a slip of paper annexed thereto or so signs for the same purpose a stamped paper intended to be completed as a negotiable instrument, he is said to endorse the same and is called the endorser".

An endorser of a cheque creates three legal consequences: (*a*) transfers all his right, interest and title of the instrument to the endorsee, (*b*) guarantees the genuineness of the instrument and also of the signatures preceding his signature, (*c*) undertakes to compensate for any loss in case of non-payment of the instrument even if presented strictly in accordance with its tenor.

The endorsement should necessarily be of the entire instrument for the purpose of negotiation. A partial endorsement purporting to transfer a part of the value of the instrument does not indicate the negotiation of the instrument. A regular endorsement is what purports to be the endorsement of the payee. The endorse-

ment must be according to the spelling in the body of the instrument in order to be correct.

When the space for writing endorsement on the back of an instrument is filled up, a slip is attached whereon further endorsements may be recorded. The slip is called "Allonge".

Different Classes of Endorsement

1. *Blank, i.e.,* only signature.
2. *Special, i.e.,* Pay to A or order sd/B.
3. *Partial*—only part of the amount is sought to be transferred. It is no negotiation.
4. *Restrictive*—(*a*) where it restricts further negotiation as "Pay A only", (*b*) restricts the choice of the endorsee as "Pay to A or order for collection".
5. *Sans Recourse, i.e.,* in India it means "without recourse", where the endorser clearly indicates that the subsequent holders should not look to the endorser for payment in case of dishonour of any instrument.

Bankers and Endorsement

A banker, before paying a cheque, must have to satisfy himself about the correctness of the endorsement on the cheque. Under section 85 of the Negotiable Instruments Act, "where a cheque payable to order purports to be endorsed to or on behalf of the payee, the drawee is discharged by payment in due course." A paying banker will not be held responsible for any forged endorsement which apparently appears to be in order on the face of it, as it is not possible for a banker to know the exact signatures of all the endorsers. Payment in due course means payment in the regular course of business and in good faith. If any banker pays any cheque outside the banking hours, that will not constitute a payment in due course. So care should be taken that payments are not made outside the appointed business hours, lest the paying banker should lose protection. Bankers are often approached by clients for payments outside banking hours and they, as a matter of practice, have to make payments for obliging those customers. Though in Baines *vs.* The National Provincial Bank, it has been

decided that the banker has the right to deal with any cheque within a *reasonable* business margin after the advertised time or hours, still there is a conflict of views as to what constitutes a "reasonable margin". Discouraging the practice of making payments of cheques in late hours, the Reserve Bank of India issued the following circular:

Ref. No. DBO. 100/94-45 dt/30th August, 1945—

"Our attention has been drawn to the practice prevailing with certain scheduled banks of making payment of cheques in cash after normal banking hours. Such a practice, in our opinion, is undesirable as it not only involves unfair competition between banks which observe recognised banking hours and those which do not, but also leads to delay in the balancing of books and imposes a heavy strain on the staff. A more serious objection to this course is that when the constituents of banks are accustomed to such facilities in normal times, they would insist on similar concessions in emergencies thus placing the banks in an unenviable position at a time when their liquid resources are being fast depleted by withdrawal of deposits. Where the banks affected have large liquid resources and are situated in places where financial accommodation is available from the Reserve Bank, it may be comparatively easy for them to pay their depositors even after office hours, but there will be banks in other places which may require some time to arrange for unusual withdrawals and in such cases strict adherence to the normal banking hours will be of material assistance to them. In the general interest therefore it would seem advisable that the depositing public should be educated to expect repayment of bank deposits only during specified hours, and that any requests for payment outside such hours should be discouraged. Apart from the above considerations, it is doubtful, whether from the strictly legal point of view, payment of cheques after office hours is, in all cases, payment 'in the ordinary course of business' and there is a risk of such payments losing the protection provided by section 85 of the Negotiable Instruments Act. Banks are, therefore, requested to refuse, if they agree with the soundness of the principle set out above, to encash such cheques etc., after the normal banking hours. This suggestion does

not apply to the payment, after banking hours, of cheques already presented before the closing time which may be paid in accordance with the usual banking practice."

Additions to Payee's Name

If a cheque is drawn payable to A only, the instrument becomes non-transferable. Payment should be made to A alone on proper identification or on the collecting bank's guarantee. A cheque drawn in favour of "bearer, my wife" or "bearer, my wife or order" is required to be endorsed. A cheque made payable to "bearer A or order" should be endorsed by A. A cheque drawn "Pay bearer or order" may be paid without endorsement as the drawer by inserting "bearer" evidently means it to be so payable. If the drawer of a bearer cheque writes the name of the payee over the word "bearer" partially obliterating it, the safest course would be to consider it payable to "order".

Anomalous Persons.—Cheques drawn like "Pay wages or order" are treated as bearer cheques, according to the principle that a cheque made payable to a "fictitious or non-existing person should be treated as payable to bearer".

Impersonal Persons.—Cheques drawn payable to impersonal payees like "Pay income-tax order" or "Pay Government Loan order" should not be considered as payable to bearer. It must bear the endorsement of the appropriate authorities.

Cheques drawn as "Pay A or ('or' struck off) bearer" often create much confusion as to the true motive of the drawer for striking off "or" only. Some are of opinion that by striking off "or" the drawer is intending to particularise the payee A and likes the payment to be made to A alone and none else. If this contention is accepted, the cheque must have to be endorsed by A and ceases to be payable to bearer. But there are others who are inclined to treat such cheques as payable to bearer. Their argument is that while making a payment, the banker examines whether the word "bearer" or "order" has been struck off or not and not "or" which does not form a material part of the cheque. So if the word "bearer" remains intact and "or" is struck off that cannot rob the cheque of the peculiarities of "bearer". In our opinion, the cheque should be treated as a "bearer cheque."

Endorsement in Pencil.—Some bankers insist on an endorsement in ink. Others raise no objection to a pencil endorsement where the cheque bears more than one endorsement after the pencil endorsement, which shows its negotiation and the paying banker should not refuse payment on this ground.

Endorsement with Courtesy Titles.—In such cases courtesy titles like "Mr", "Sir", "Lord", "Rai Bahadur", "Dr" etc., should not be given while making endorsement. Endorsements should be given without those titles. But endorsement like "A.M.D." or "A. Captain" will be right, as M.D. and Captain put at the end are merely descriptive.

Endorsements of Married Women.—Cheques drawn in favour of "Mrs. John Smith" should be endorsed under Mrs. Smith's usual signature, followed by an expression showing that she is Mrs. John Smith. Thus endorsement like Alice Smith, wife or widow of John Smith is quite in order. If the cheque was drawn to a married woman in her maiden name, she should endorse as "Alice Smith=(Née Jones)".

Endorsements of Official Payees.—A cheque drawn in favour of B, trustee, should not be endorsed as "B" but as "B, Trustee". When the payee is so described as to indicate that the money is paid to him in his official or fiduciary capacity, his endorsement must include a statement of that capacity.

Per Pro Endorsement.—Per pro endorsements like "Per Pro Bird & Co., B. Mukherjee" do not require any official designation.

Endorsements of Firms and Joint Persons.—Cheques drawn in favour of "Birla & Co." should be endorsed like "Birla & Co." Cheques drawn like "Messrs. Smith" may bear either of these endorsements—"Smiths", "Smith & Smith", "Smith & Son", "Smith Bros.", "J. Smith & S. Smith". Cheques drawn payable to "Smith Bros." should be endorsed as "Smith Bros." and not as "S. Smith & J. Smith", because these endorsements do not show that S. Smith & J. Smith are brothers. A cheque payable to "Messrs. Smith & Jones" may be endorsed as "Smith and Jones" or in two hand-writings John Smith, H. Jones. A cheque drawn in favour of "Sir D. P. Sarvadhikery & Co." may be endorsed as Sir D. P. Sarvadhikery & Co., or For Sir D. P. Sarvadhikery & Co.—A. Mitra, Partner. Here "Sir" should not be omitted being a courtesy title, as it forms a material part of the name of the

firm and makes it distinct from another firm named D. P. Sarvadhikery & Co.

Joint payees will have to endorse severally. Sheldon observes that "if a cheque is payable to two payees jointly, and one of them dies before presentment the cheque is *payable to the survivor* on his endorsement provided he can produce satisfactory evidence of the death of the other party."

Endorsements of Joint-Stock Companies.—Cheques drawn in favour of "Martin & Co. Ltd" may be endorsed as "For Martin and Co. Ltd." B. Mukherjee, Agent/Secretary.

Illiterate Persons.—A payee unable to write may endorse by means of a mark or thumb-impression, preferably of the left thumb. That mark or thumb-impression should be witnessed by some one else known to the bank with his or her address. Preferably two witnesses should so certify. The bank official should not be a witness in such cases to avoid trouble.

Endorsements of Cheques Payable to Deceased Persons.—In such cases the cheques should be endorsed by the legal representative of the deceased persons.

A cheque payable to "A per B" and endorsed as "A" should be returned asking for confirmation, as the endorsement does not disclose the relationship of A to B as indicated in the cheque.

Some Examples of Endorsements

INDIVIDUALS	IRREGULAR	REGULAR	REMARKS
Lala Sankar Lal	Lala Sankar Lal	Sankar Lal	'Lala' being courtesy title should be omitted.
Mr. Gary Cooper	Mr. Gary Cooper	G Cooper	Permissible in the case of Christians only.
Principal Sen	Principal Sen	A K Sen	
Sir D. P Sarvadhikery	Sir D. P. Sarvadhikery	D. P Sarvadhikery	'Sir' being courtesy title should be omitted.
Dr. A. K. Ghosh	Dr. A K. Ghosh	A. K Ghosh A. K. Ghosh, M.B.	
P. Ghosh per B. Bose	B Bose	P. Ghosh per B Bose	Same as written.

Some Examples of Endorsements—*Contd.*

WOMAN			
Mrs. Ghose	Mrs Ghose	Kamala Ghose, wife of A. K. Ghose (Mrs.) Kamala Ghose	
Mrs. K Desai	Mrs. K. Desai	Lila Desai, wife of Mr. K. Desai	
Miss K. Desai (now married)	Miss K. Desai	K Divanji (née—Desai)	
JOINT PAYEES			
Bijon Sen & Rabin Sen	Bijon Sen & Rabin Sen (in the same handwriting)	Bijon Sen Rabin Sen	In separate hand-writing.
Bijon Sen & Mrs. Sen	Bijon Sen & Mrs. Sen	Bijon Sen Manika Sen	In different hand-writing.
		or	
	*	For self & Mrs. Sen Bijon Sen	Authority presumed.

Payment of Cheques.—Under section 85 of the Negotiable Instruments Act, it has been laid down that "where a cheque payable to order purports to be endorsed by or on behalf of the payee, the drawee is discharged by payment in due course". So the primary concern of a banker in such a case is to satisfy himself about the correctness of the endorsement. The banker will be protected under sub-section (2) of section 16 of the Negotiable Instruments Act if the endorsement is in order apparently, although it might transpire later on that the endorsement was a forged one. But this protection can be claimed by the paying banker if he pays the cheque or draft drawn on him in due course. Let us now examine what is meant by payment in due course.

Payment in Due Course.—Under section 10 of the Negotiable Instruments Act, "payment in due course means payment in accor- with the apparent tenor of the instrument, in good faith and negligence to any person in possession thereof under nces which do not afford a reasonable ground for believ- he is not entitled to receive payment of the amount therein d".

If a cheque becomes due for payment and is accordingly paid, it will be equivalent to payment in due course. But it will not be so in respect of payment of a post-dated cheque or of a cheque which has become out of date. Nor is the payment of a cheque out of business hours to be considered as a payment in due course.

In Good Faith and Without Negligence.—It will be an act of negligence if the paying banker fails to see whether all endorsements on the back of the cheque are in order. It is to be examined that all are correct endorsements. If any endorsement happens to be incorrect, the paying banker will be charged with negligence. Similarly, if there be any endorsement with *per pro,* the paying banker is to satisfy himself that the person so signing bears the necessary authority.

Person in Possession of the Instrument.—In case the payment of a cheque coming into the possession of a person, is countermanded by the drawer, it is natural to presume that the person is not entitled to receive payment of the same.

Payment of Crossed Cheque.—Under section 128 of the Negotiable Instruments Act, it is laid down that "where the banker on whom the crossed cheque is drawn has paid the same in due course, the banker paying the cheque, and (in case such cheque has come to the hands of the payee) the drawer thereof, shall respectively be entitled to the same rights and be placed in the same position in all respects as they would respectively be entitled to and placed in if the amount of the cheque had been paid to and received by the true owner thereof".

But when the paying banker also acts as the collecting banker, he cannot claim the protection which would be denied to the collecting banker on the ground of negligence (Carpenters Company *vs.* British Mutual Banking Company).

When Payment Must be Refused

(1) When payment is countermanded by the drawer under advice to the bank, the cheque should be returned with the remark "orders not to pay" or "payment countermanded by the drawer". The remark "payment stopped" might mislead the people to think that the customer might have suspended payment due to insolv-

ency. Sometimes notice to stop payment of a cheque is given by the drawer either over the phone or by telegram. Such a notice to be binding upon the bank must have to be confirmed in writing. On receipt of such a telegram or phone, the bank should at once ask for the written confirmation of the drawer and in case the cheque is presented before the written confirmation is obtained, the bank should return the cheque with the remark, "payment countermanded by phone or telegram—awaiting confirmation". Sometimes a banker is requested by the payee of a cheque not to pay it. The only person who can instruct the banker not to pay a cheque is the drawer ; but the banker, having received notice from the payee, would endeavour to get into touch with the customer before paying the cheque. He should not pay it if it is payable to order and the payee states that he has not endorsed it.

Sometimes the bank frames such a rule of business that "the bank will register instructions from the drawer of a cheque to stop payment of it but it cannot undertake any responsibility in case such instructions are inadvertently overlooked". But this rule will not be able to protect the bank if it makes payment of a cheque, which the bank was notified not to pay by the drawer.

(2) Upon receipt of a notice of the drawer's death, the bank will be justified in refusing payment of the cheque drawn by the customer before his death but presented after his death. But if the principal customer authorises his agent to draw cheques and the said agent dies, the cheques drawn by him prior to his death should be honoured by the bank, because the principal's authority still subsists. But if the principal dies, the cheque should be refused under reason "*Principal* deceased".

(3) If the customer becomes insolvent, then the cheque drawn by the customer should be refused payment. But this step can be taken only when the order of adjudication of his insolvency has been passed and the bank has been notified thereof. The same step should be taken when the customer becomes insane.

(4) On receipt by the banker of the notice of assignment by the customer of the credit balance in his account.

(5) In the case of a trust account when it is observed by the bank that there is going to be a breach of trust on the part of the customer.

(6) On knowledge of any defect in the title of the party presenting the cheque.

(7) Irregular endorsement.

(8) Notice of a garnishee injunction or other order restraining the customer from operating on the account.

Upon receipt of such restraining order the banker should at once notify his customer of the order of restraint and will have to refuse payment of the cheque drawn by him. If the order attaches the whole balance of his account, less uncleared cheques, the customer should be informed that he may open a new account for future credits. A garnishee order is an order of the court, obtained by a judgment creditor, attaching funds in the hands of a third party who owes the judgment debtor money, warning the third party (the garnishee) not to release the money attached until directed by the court to do so: The garnishee should not pay over the funds until an order *nisi* is made absolute. A garnishee order served on a banker (garnishee) applies to the whole of the customer's balance on current account and until the order is withdrawn the account must remain inoperative. It applies to the debt due or accruing due from the bank to the customer. But when the judgment debtor happens to be a party to a joint a/c, the joint a/c cannot be attached by the garnishee order. When a garnishee order is served on the Head Office of a bank against a customer having an account with a branch, the order should be forwarded to the branch concerned without delay and the account should be stopped. But if that branch happens to exist in a foreign country, that garnishee order will not be binding on the bank.

A deposit repayable only after notice is probably not attached by a garnishee order unless notice of withdrawal has been received before the service of the proceedings (Cowley *vs.* Taylor). If a further condition of repayment of the deposit is the return of the deposit receipt or pass book, the late Sir John Pagot was of opinion that this condition must also be fulfilled before the deposit

becomes attachable. This opinion is confirmed in Bagley *vs.* Winsome.

Some Notes on Payment of Cheques

1. A cheque payable to a bearer is always a bearer, even though it might bear an endorsement to order on the back.
2. If a cheque is written as "bearer" at the beginning bearing the space blank but the printed matter "or order" at the end remains unaltered, it will be treated as a "bearer cheque", since the written word "bearer" overrides the printed words "or order".
3. If a cheque is drawn "Pay...A or—" it requires the endorsement of A.
4. If a cheque is drawn "pay A only" it becomes a non-transferable cheque. The banker should pay only to A and nobody else.
5. A bank should not attempt to stop payment of its own draft which is equivalent to the bank's promissory note. Unless the draft is crossed "not negotiable", payment of it can be preferred by a holder in due course, even if, without his knowledge, the draft is tainted with fraud or illegibility since it left the customer's hands. No one, however, can be a holder under a forged endorsement, and if the customer can satisfy the bank that the draft has been lost or stolen, without having been endorsed by the payee, it may, if presented bearing an endorsement purporting to be the payee's, be returned with the answer "Draft stated to have been lost. Payee's endorsement requires verification".

   A cheque drawn as "Pay yourselves or order" is presumably intended to be delivered to the bank in payment for some service to be rendered by the bank. It should not be cashed or dealt with in any way, without the express instructions of the drawer.

Advising Fate by Telegram.—Sometimes the paying banker is asked by the collecting banker to inform by wire whether a particular cheque will be paid. In such a case, the paying banker,

without making any commitment whatsoever provided there is sufficient balance for the purpose, should intimate in the following manner, *"would be paid if presented here now and in order"*.

Collecting Banker

A banker may collect cheques for his customer, when he becomes a holder in due course. But when he receives cheques in specific settlement of an account, and where he expressly or impliedly allows his customer to draw against cheques before collection, the banker becomes a holder for value. To constitute value there must be a contract between the banker and the customer, express or implied, that the bank will, before receipt of the proceeds, honour cheques drawn against the uncleared cheques. But the placing of a crossed cheque to the credit of a customer's account before clearance will not be considered as holding for value.

Rights as Holder for Value.—While the banker becomes a holder for value, and the cheque he holds bears a forged endorsement, he is to refund the money to the true owner. But he has the right to recover the money from the customer, from whom he received the cheque. According to Sir John Paget, if the banker is not simply collecting but takes the uncrossed cheque as holder for value, he occupies exactly the same position as any other person who so acquires the cheque. If there is forged endorsement, he is liable to the true owner and acquires right only against endorsers, if any, subsequent to the forgery. If there is no forged endorsement, but only defective title or no title on the part of the customer, then the banker is a holder in due course with good independent title against everybody, entitled to hold, and sue all prior parties on the cheque.

Bank as an Agent.—While a banker acts as an agent for his customer for collecting a cheque, he is protected under section 131 of the Negotiable Instruments Act, which runs as follows:

"A banker who has in good faith and without negligence received payment for a customer of a cheque crossed generally or specially to himself shall not, in case the title to the cheque proves defective, incur any liability to the true owner of the cheque by reason only of having received such payment.

As an explanation thereto a banker receives payment of a crossed cheque for a customer within the meaning of this section notwithstanding that he credits his customer's account with the account of the cheque before receiving payment thereof."

What is Meant by Receiving Payment in Good Faith and without Negligence.—About the exact meaning and extent of negligence the bankers and lawyers are seldom agreed. Bankers complain that the question of time, pressure and exigencies of business make it physically impossible for a banker to observe all the precautionary measures imposed by law. But the law will be no respecter of persons or of circumstances but shall take its own course. It is observed that negligence under this section is somewhat artificial, as there can be no negligence if there is no duty and in such a case there is no contractual obligation between a banker and the true owner while collecting a cheque for his customer. But still it is being imposed on a banker as a statutory obligation. So negligence is a matter of circumstances. Broadly speaking, the banker must exercise the same care and forethought in the interest of the true owner, with regard to cheques paid in by the customer, as a reasonable business man would bring to bear on similar business of his own.

It will be a matter of negligence on the part of a banker if he fails to scrutinise the endorsement. Such is the case when a cheque payable to two different persons is being endorsed in the same handwriting. An act of negligence will be committed by a banker, when he credits the proceeds of a cheque payable to a firm to a partner's private account (Morison *vs.* London County & Westminster Bank Ltd.). Similarly, it will be an act of negligence if a bank opens any account without proper introduction and credits the proceeds to that account of a cheque payable to someone else, on his misrepresenting himself as the payee and endorsing the cheque accordingly (Ladbroke & Co. *vs.* Todd). It would be obvious negligence to collect for a man's private account cheques made payable to him in his official capacity.

The question has more than once been raised whether the existing condition of a customer's account ought to influence the banker's mind when that customer pays in a large cheque for collection. It is now decided that this is not a matter for the bank to inquire.

In Midland Bank Ltd. *vs.* Reckitt it was decided that the bank was negligent when it permitted credit to the private account of the solicitor of a cheque drawn by him as the constituted attorney of his client. Similar was also the decision in Lloyds Bank *vs.* Chartered Bank of India, Australia and China (1929).

In Underwood Ltd. *vs.* Bank of Liverpool it was held that the bank committed negligence as it permitted credit of the company's cheque to the private account of a Director.

Sometimes a customer wishes to adopt one of the following forms of cheque bearing on the back or at the foot, a form of receipt intended to be signed by the payee:

(*a*) Pay...........or order on the receipt being duly stamped, signed and dated.

(*b*) There is no reference to the receipt in the body of the cheque, but under the receipt appear the words 'Receipt must be stamped, signed and dated.'

(*c*) The body of the cheque being as in (*b*) the note printed under the receipt runs:

'Signature of the receipt is intended to have effect as an endorsement of the cheque'.

The following procedure should be adopted in dealing with these cases.

(*a*) That the receipt is to be duly stamped, signed and dated implies a condition of payment and the document, therefore, ceases to be an unconditional order. The drawee banker should ask his customer for an indemnity to the effect that the banker shall have same protection and rights as though the documents were unconditional order payable to order on demand, and as though the signature of the receipt were an endorsement purporting to be made by the person named as payee. Such a conditional order is not negotiable and apparently is not even transferable.

(*b*) In this case it has been held that the words appearing at the foot are directions to the payee, not to the paying banker (Nathan *vs.* Ogdens) and consequently the docu-

ment is not conditional and is therefore a cheque. The banker should, however, obtain an explicit instruction from the customer whether or not he is to pay such a cheque when the receipt is not signed or is in any way defective though the cheque appears to be duly endorsed by the payee.

(c) The question is whether a single signature can in law be both a signature of the receipt and an effective endorsement of the cheque. The late Sir John Paget was of opinion that it could not. He said, "there is no legal authority that endorsement can be effected by a signature which concurrently fulfils another end. The animus indorsandi can hardly be predicated in such a case. To remove doubts, the customer should be asked to sign an indemnity expressly providing that signature of the receipt is to have effect as an endorsement of the cheque."

Conversion

Conversion is a legal term signifying wrongful interference with another person's property, inconsistent with the owner's right of possession. It has been defined as follows: "Any person who, however innocently, obtains possession of goods, the property of another, who has been fraudulently deprived of the possession of them and disposes of them whether for his own benefit or that of another person is guilty of a conversion". A banker will be accused of conversion if he misdelivers any article to an un-authorised person. When he collects a cheque for a party who has no title or a defective title to it, he is liable for conversion subject to the protection given in section 131 of the Negotiable Instruments Act. The instances of negligence on the part of a bank cited above are likely to subject a bank to the charge of conversion. In cases of cheques issued in favour of third parties, extra caution should be applied by the bank lest it should be charged with conversion on account of certain irregularities in the cheques (Motor Traders Guarantee Corpn. Ltd. *vs.* Midland Bank Ltd.). If a draft issued by a bank is delivered to the payee, its repurchase by the bank without the latter's consent would appear to be a conversion for which the bank may be liable.

Clayton's Case

This is the name of a case which is always referred to as the leading authority upon what is known as the "appropriation of payments". If a debtor owes more than one debt to his creditor, and pays him a sum of money insufficient to liquidate the whole of the debts, it is a matter of importance to know to which debts the payment is to be appropriated. From Clayton's case the following principles are derived:

(1) A debtor making a payment has a right to appropriate it to the discharge of any debt due to the creditor;

(2) if at the time of payment there is no express or implied appropriation thereof by the debtor, then the creditor has a right to make the appropriation;

(3) in the absence of any appropriation by either debtor or creditor, an appropriation is made by presumption of law, according to the items of account, the first item on the debit side being the item discharged or reduced by the first item on the credit side. It is the sum first paid in that is first drawn out.

In Bradford Old Bank *vs.* Sutcliffe, where there were two accounts, it was held that the two accounts could not be considered as one, and that payments to the credit of the current account are appropriated to that account and cannot be taken in reduction of the loan account. The principle of Clayton's case does not, however, apply where a person has mixed trust moneys with his own moneys in his account. The money which he first withdraws from the account is taken to be his own money leaving the trust funds intact. But if the trust moneys of several persons have been paid into a customer's account the position is different. Where a solicitor had paid into his account moneys belonging to various clients, it was held that the rule in Clayton's case applied at between claimants to the trust moneys in the first trust money paid in as the first money drawn out. The rule in Clayton's case is a rule of evidence and not of law. A clause in a bank's form of charge or guarantee designed to avoid the operation of the rule will be efficacious (Westminster Bank *vs.* Cond).

Collecting Banker and Customer

In the matter of collection of cheques and other negotiable instruments a banker is to show *due care* and diligence. If he fails in his duty, he becomes liable for the loss sustained by a customer on account of his default. As a collecting banker, it is his duty to present the cheque within a reasonable time, which is usually meant to be the next working day after the receipt of the cheque. If it can be proved that there was delay on the part of the collecting banker to present the cheque in time and in the meantime the drawee bank suspends payment, the banker is answerable for the loss of the customer. In a case, Forum *vs.* Bank of England, the bank was held guilty of negligence, as the bank presented the cheque through county clearing, instead of through town clearing according to the banking practice.

In case a cheque is dishonoured, the same should be returned to the party with the copy of the objection-memo, without loss of time.

Payment of Money through Mistake

The legal position regarding the recovery of money paid through mistake is not certain, nor free from controversies. However, from different legal decisions about this matter certain broad conclusions can be drawn which will throw some light on the issue.

If a banker pays by mistake to a payee, who is conscious that he is not entitled to the payment, the payer has the right to recover the money. But in case a banker gives credit to a customer, through mistake, a larger sum than due and the said customer is made to alter his position on the basis of that credit in good faith, the money is not recoverable as decided in Skyring *vs.* Greenwood and also in Holt *vs.* Markham. A question arises whether a banker is protected in having paid a bill drawn upon and purporting to be accepted by a customer payable at his bank, if it is afterwards discovered that the acceptor's or an endorser's signature is a forgery and also whether on discovering the forgery it is in order for the banker to recover the amount of the bill from the person to whom he has paid it, if that person received the money

in good faith. In the case where the customer's signature is forgery, the late Sir John Paget thought that a court would be astute to debar a banker from recovering money he had paid to an innocent person on a forgery of his own customer's signature. In the second case where the endorser's signature is a forgery Sir John Paget considered that money paid on a negotiable instrument to an innocent person could not be recovered if he had the money in his possession for such a period that his financial position might, not necessarily would, be affected if he had to refund.

Again money paid away under mistake of fact can, under certain circumstances, be recovered. Before recovery it must have to be proved that the mistake is one of fact, not of law. If the money which is payable to A is paid through mistake to B, it is a mistake of fact and the payer has the right to recover the money. But if any payment towards indebtedness is made in spite of the expiry of the period of limitation, which is a mistake of law, it is not recoverable. Sir John Paget observes, "money paid to a man as principal, not agent, under mistake of fact can be recovered against him, although he has detrimentally altered his position, if he did so merely in consequence of the payment and not in reliance on some independent act or representation of the payees or by some breach of duty on the party's part, or unless the mistake of fact directly touches a negotiable instrument by virtue of which he received the money, and his position has been or might have been prejudiced in the interval between payment and reclamation". The following conditions must be fulfilled before recovery can be claimed:

(1) The mistake must be between the payer and the receiver (Chambers *vs.* Miller). If the mistake lies between the banker and the customer, who happens to be the drawer of the cheque, and the payment is made to an innocent holder of the cheque through misreading of the drawer's balance, the money so paid shall not be recoverable from the recipient of the payment.

(2) That the money has not been paid to an agent who has paid over to his principal.

(3) That the money has not been paid to a principal who would suffer if forced to repay. He must, however, have

been induced to change his position by some representation on the part of the payer, and not merely as a consequence of the payment.

(4) That the money has not been paid on a negotiable instrument. But if the mistake relates to the instrument itself and not to anything extraneous to it, money paid on such an instrument may be recoverable.

ACCOUNTS

A current account is an active or running account on which cheques are drawn and to which credits are paid.

A current account should not be opened without proper introduction or satisfactory reference. No cheque book should be issued unless reference about the party has been received. A bank opening any account without introduction loses protection under section 131 of the Negotiable Instruments Act (Ladbroke *vs.* Todd). A reference from a stranger without establishing his *bona fides* should not be acted upon. If a customer happens to be an employee details of his employer should be ascertained and in opening an account in a married woman's name, details of her husband and her husband's employer should be taken to prevent any fraudulent dealings with the employer's cheques (Lloyds Bank Ltd. *vs.* E. B. Savory & Co.).

A specimen of the customer's signature should be taken properly certified by the bank official, and preserved properly indexed in a safe place. It is to be examined that the necessary particulars in the account opening forms are completed by the customer, with his full name, address and occupation and any relative instruction with regard to the mode of operation on the account. All these particulars with the names of the signatories should be entered in bold characters on the top of the Current Account Ledgers.

If a customer desires any one else to operate on his account, he will have to sign a mandate authorising that person and confirming his specimen signature and deliver the same to the banker. The banker must not permit any overdraft if the authority does not permit of any overdrawing by the authorised person. Such mandates should be carefully preserved and a note thereof be kept on the top of the ledger folio.

Minor or Infants.—Under the Indian law a person will be regarded as a minor until he completes his 18th year. But if before the completion of his 18th year, a guardian is appointed by the court, his minority extends to the age of 21 (Sec. 3 of the Indian Minority Act IX of 1875). Under the English law a person will be attaining majority on the completion of his or her 21st year. As a minor has legal disability with regard to the making of contract, he can repudiate any such contract on attainment of majority. Still an account may, however, be opened in the name of a minor, provided it is in credit balance. But if, for any reason, the account is overdrawn, that money cannot be recovered from a minor. So it is to be carefully observed that the account of a minor is never permitted to be overdrawn. For the same reason, no overdraft or advance should be granted to a minor, however acceptable be his securities. For safety's sake, it is advisable to open such accounts in the name of his natural or legal guardian.

Though the minor has no capacity to contract he may still be appointed an agent for another person, competent to enter into contract, provided the latter authorises the former. In such a case the minor acting as an agent can enter into all sorts of contract on behalf of the principal if he possesses necessary powers from the latter. He may there overdraw even his principal's account if that power is included in the authority.

There is no harm in a minor being a partner. But the danger is that he may repudiate his debts on attainment of majority. Now in case he does not repudiate the debts contracted before his majority, within six months of the attainment of his majority, the debts will be considered to have been ratified by him (Section 30 of Indian Partnership Act, 1932). If a minor by a false representation as to his age induces a banker to enter into a contract with him, he cannot afterwards obtain relief by pleading that he is below the age. An infant cannot be made liable on a guarantee. In case of his death a letter of administration is to be taken out by his father or mother or the nearest kin.

A deposit receipt may be issued in the name of a minor for which he is able to give a valid discharge.

Lunatics.—Under the English law any contract made with a person of unsound mind is not void but voidable. But in Indian law such a contract is absolutely void and not simply voidable.

When a banker comes to know of the insanity of a customer, he should at once suspend operation on the said customer's account. But in such a case the banker must not act on mere hearsay or gossip ; he must be reasonably satisfied that his customer is incapable of understanding business transactions. A certificate to that effect by two medical practitioners will be considered sufficient for the purpose. Mental unsoundness, if the patient is thereby rendered incapable of managing his affairs, determines any authority that he may have given to an agent to act for him. A power, even during the period of irrevocability, is revoked by the customer's becoming incapable of managing his affairs.

The joint authority to operate on an account is in effect an authority by each for the other to draw and, like any other authority, must be considered to be determined by mental incapacity of either signatory.

Drunkards.—Contracts with drunken persons are voidable but not void. If the contract is voidable, it must have to be proved that the person signing the contract was incapable of drunkenness. Drunkenness is no answer to a holder in due course, but to an immediate party with notice of the drunken state. When a drunken person draws a cheque over the bank's counters and insists on payment, it is advisable to have the signature witnessed for safety's sake.

Married Woman.—A married woman can open an account with the bank, as he suffers from no legal disability as to her contractual capacity. At the time of opening such an account, a banker will do well to ascertain her husband's name and his occupation with the name of his employer, if any, so that any fraudulent dealings with the husband's employer's cheques may be guarded against.

A married woman cannot make her husband responsible for her personal debts, unless it can be proved that she acted as her husband's agent and incurred those debts for meeting the necessary household expenses. Under the Law Reform Act, 1935, a married woman in England can acquire, dispose of any property she likes, just like an unmarried woman.

Where a married woman has a joint account with her husband, her right to any credit balances on the death of her husband is a question of intention on the husband's part. In such

a case to avoid any difficulty it is advisable for a bank to get a clear mandate as to the ownership of the balance if any one dies. Where a married woman guarantees husband's debts, she should be separately advised by the solicitor that she has understood the terms of the document and put her signature thereon freely and voluntarily.

Joint Accounts.—Here those joint accounts will be considered which are neither partnership accounts, nor trust accounts. Such accounts should be opened under the joint signatures of the account holders and all instructions regarding the operation of the account jointly or severally should be confirmed under joint signatures, to be binding upon the bank. A clear mandate should be taken from them as to whether the money is payable to either or survivor in case of death of any, although the natural presumption in such a case is that the balance should be at the disposal of the survivor. A satisfactory evidence of the death of a joint party should have to be produced, before the other persons authorised to operate on the account are allowed to do so.

If the banker receives notice that the joint account is, in reality, a trust account, the banker should not allow the survivor to withdraw the balance. Difficulties are experienced when the legal representatives of the deceased joint account holder lodge claim to the balance. In such a case Sheldon holds this opinion that, apart from express agreement, the ordinary principle of a joint debt applies, and the banker is entitled to pay the surviving party the balance on satisfactory proof of death. As to whether the survivor is the beneficial owner of the balance is a matter to be settled between him and the legal representatives. Meanwhile, the survivor holds that part of the balance, provided by the deceased, as trustee for the later's estate. The legal representatives of the deceased cannot prevent the bank from paying the balance to the survivor unless they get an order of restraint from the Court.

In the event of the bankruptcy of any of the joint account holders, the banker should stop all operations on that account pending instructions from the other and the trustee in bankruptcy. The cheque drawn by the bankrupt person or by the insolvent joint party should be returned under ground "Joint account holder in bankruptcy".

On the death of a joint party it is advisable to stop that account and ask the survivor to transfer the balance for the purpose of opening a new account. On the death of all the joint parties any balance is payable to the legal representatives of the one that died last.

Cheques drawn on a joint account may be stopped by any of the signatories.

Any joint account holder has not the implied authority to pledge each other's credit. So if an overdraft is to be created, that must have to be confirmed by all the joint account holders. The confirmation of any one of the signatories will not do in respect of overdraft, unless all the signatories jointly concur in such an arrangement.

In the case of a joint aoccunt in the names of a husband and wife, if the account is opened by the husband for his convenience, the balance, in the absence of any written mandate to that effect, cannot be claimed by the widow but is to be transferred to the deceased's estate, as decided in Marshall *vs.* Crutwell. But if the account is intended to be opened for the provision of the wife, only she can claim the balance (Foley *vs.* Foley).

A joint account is opened by a husband and wife either having power to sign cheques. A cheque is presented in the handwriting of and signed by the wife, and altered and duly signed by the husband. It will be in order for the bank to pay the cheque.

If one of the joint account holders dies and the account is in credit, the name of the deceased account holder should be ruled out of the ledger heading, a note being made of the date of his death, and the survivor or survivors should be allowed to continue the account without a break. If the account is overdrawn, the liability for the overdraft, unless the account holders were partners or had signed an agreement to be both jointly and severally liable to the bank, is joint only and on the death of one his estate is discharged from the debt. If the parties had signed an undertaking of joint and several liability and it is desired to preserve the liability of the deceased's estate, the account should be broken ; otherwise under the Clayton's case, credits paid in after his death will go in reduction of his liability.

Partnership Accounts

According to section 4 of the Indian Partnership Act, 1932, "a partnership is the relation between persons who have agreed to share the profits of the business, carried on by all or any one of them acting for all". It is not necessary that a partnership firm is required to be compulsorily registered. If it is so registered, it can bring its claims as against other partners in the court of law. This protection cannot be claimed by an unregistered partnership firm.

Opening of such Account.—A banker is free to open a partnership account, if it is applied for by one or more of the partners. He is to scrutinise the provisions of the partnership agreement, if any, to find out if there is any instruction relating to the operations of the accounts. If nothing is mentioned about these matters, any partner is authorised to draw cheques in the firm's name, and by doing so he will bind the firm. Usually the banker has his own prescribed form which all the partners jointly sign undertaking liabilities jointly and severally.

Before the banker opens such an account, he obtains specific instructions from the partners as to whether any one or more will jointly or severally operate on the account. One partner has power to countermand the payment of cheques drawn by another.

Transactions on Private Accounts

The banker should not accept any cheque drawn in favour of the partnership firm for credit of the partner's private account lest he should be charged with negligence and lose protection under section 131 of the Negotiable Instruments Act.

Death of a Partner.—On the death of a partner, the partnership is dissolved. On receipt of the notice of such death, the banker should stop the account and ask the surviving partner to open a new account. The cheque drawn by the deceased partner prior to his death should not be paid unless confirmed by the surviving partners. If the account be an overdraft account, the debt of the partner will not be extinguished on his death but his estate will be charged for the liquidation of his indebtedness.

Retirement of a Partner.—On the retirement of a partner his previous debt is not extinguished, but he cannot be held responsible for future indebtedness if the bank is only notified of his retirement. If no such notice of retirement is given to the bank, he cannot be exonerated from subsequent indebtedness to the bank. If the banker does not like to exempt the retiring partner from his past indebtedness, he will ask the firm to close the present account and open a new one to stop the application of the rule in Clayton's case, according to which a payment shall discharge the earliest debt, whether of the customer or of the banker remaining unpaid.

Insolvency of a Partner.—By the operation of law a partnership is dissolved with the insolvency of a partner. If a partner is adjudicated an insolvent, the cheque drawn by him should be returned unless confirmed by other partners. The other partners may, however, withdraw the credit balance to account for the insolvent's share in the firm's assets to the trustees for the bankrupt.

As regards securing of any advance by mortgage or pledge of any securities, the banker gets all such documents signed by all the partners jointly with a view to getting rid of any legal difficulty. But in India, unlike in Great Britain, a partner may bind the firm by an equitable mortgage of immovable or real property belonging to that firm.

As regards the bank's power of set-off it has already been stated that unless the partners undertake liabilities jointly or severally for the debts of the firm, the credit balance in the private account of a partner cannot be set off against the debit balance of the partnership firm.

It has already been mentioned that registration is not compulsory in the case of a partnership firm. But an unregistered firm suffers from certain legal disabilities. The partner of an unregistered firm cannot file a suit to enforce a right arising from a contract or conferred by these acts against the firm or against any person who is alleged to be a partner in the firm. On the same footing a firm cannot sue in any court a third party for any right arising from a contract unless the said firm is registered and the persons suing have been shown in the register of firms as partners of the firm. The Select Committee Report states that as the position stands at present, the third party's right to sue the firm remains unaffected, but in the case of suits by the firm or partners *inter se*

or against third parties, registration is compulsory. So the partnership firm in its own interest should get itself registered.

There seems to be no objection to opening an account with a firm, one of the partners in which is an infant. But it will be advisable to obtain an express authority signed by the other partners for the infant to sign cheques, bills and notes on behalf of the firm, if they wish him to do so.

The bankruptcy of a partner dissolves the partnership, and interest of the bankrupt partner passes to his trustee, who is entitled to have the account of the partnership taken, and to receive the bankrupt's share. The bankrupt partner's estate is not liable for partnership debts contracted after the date of the bankruptcy, and his authority to bind the partnership ceases. He cannot, therefore, operate on the account of the firm. The solvent partners are entitled to get in the assets of the partnership, to wind up its affairs, and to complete transactions begun but unfinished at the time of the dissolution. They may therefore operate on the account for the partnership purposes. If a cheque is presented, drawn on the partnership account by a partner who has committed an act of bankruptcy, confirmation by the other partners should be required.

Accounts of Limited Companies

Before the opening of the account of a public limited company, the following documents should be taken and examined by the banker:—

1. *Certificate of Incorporation*: this certificate is a conclusive proof of the fulfilment of all requirements of the companies act.
2. *Commencement certificate*: this certificate is necessary for commencing business. Without this certificate no public company can begin operations, or borrow money. If for any reason this certificate is not granted the company cannot be sued on any contract entered into pending its issue ; without this certificate money may be deposited in the company's account but no withdrawal should be permitted until the commencement certificate is obtained and produced.

3. *Memorandum of Association*: any act beyond the scope of the Memorandum, which governs company's external operations, is *ultra vires*, and not binding upon the company.
4. *Articles of Association*: contain regulations regarding the internal management of a company.
5. A copy of the resolution of the Board of Directors should have to be submitted to the bank, signed by the chairman and countersigned by the secretary of the company, confirming the opening of company's account with the banker and describing the mode of operations on the account with the names of the officials who will be doing so.

   If possible, the Balance Sheet of the company should be taken and examined so as to ascertain the financial position of the company.

Borrowing Powers.—If any company is to be given an overdraft facility, the extent of the borrowing powers of the Directors, as specified in the Articles of Association, should be examined to bank's satisfaction. When the company creates a charge in favour of the bank, which is not a pledge, that shall have to be registered with the Registrar of Companies under Sec. 125 of the Companies Act, 1956 within 21 days from the execution of the document. A register of charges should be maintained by the bank in addition and when the charge is satisfied, that should be notified in time to the Registrar of Companies.

PRIVATE LIMITED COMPANIES

In the case of private limited companies all other formalities required in connection with public limited companies will have to be observed with the exception of the Commencement Certificate which is not necessary for a private limited company. If any charge is created by a private limited company on its assets, which is not a pledge, that has got to be registered with the Registrar of Joint-Stock Companies within 21 days from the date of the ...cution of the document.

...-Trading Associations.—Societies, institutions or associa- ...ed under the Indian Companies Act, having the ... the members limited by guarantee, open accounts with

banks. The term 'limited' is not used after the end of the name, nor the word 'Company'. All formalities necessary in connection with the opening of accounts by private limited companies are to be completed with the exception of the certificate of commencement of business. Registration of any charge created by such an association is compulsorily to be made with the Registrar of Joint-Stock Companies.

Executors and Trustees.—As a rule a banker should avoid opening accounts of Trustees and Executors, as he is to shoulder enormous responsibilities. He has to carry out the operations in strict conformity with the provisions of the Trust Deed. If there is a misapplication of the Trust Fund, which, in normal circumstances, would put the banker on inquiry and the banker fails to rise to the occasion, he may be liable to the beneficiary of a trust for failure to protect the beneficiary's interest (O.R.M. *vs.* Nagappa Chettiar). The banker does not recognise any implicit trust, unless it is express.

When it is an account in the names of executors, one of them may deal with the funds of the estate on behalf of others. But when it is a trust account, all the trustees must have to sign jointly, unless otherwise stated in the Trust Deed.

On the death of any one of the executors it is not necessary for a bank to modify the course of operations on the account. But in the case of the death of any one of the trustees, a banker cannot but modify the course of the business relating to the account, as the account in case of a trust seems to be the joint business of the trustees.

If the executors borrow any funds, they are personally liable for the money, unless it is secured by the specific assets of the deceased.

Some Points Re: Executors and Administrators

(*a*) Such an account is to be stopped till a probate or a letter of administration or a succession certificate is produced.

(*b*) The probate is made up of a copy of the will bearing the sealed certificate of the court.

(*c*) Directions contained in the will should be noted in a spec[illegible]r of the bank.

Trust Accounts

Whether the following are Examples of Trust ?

Question : William Smith re John Jones.

Answer : Not a trust account—supposed to be a private account of Smith with reference to a particular transaction with John Jones

Question : William Smith account John Jones.

Answer : A trust account as the very name signifies.

Question : William Smith per John Jones.

Answer : If it means that the account has been opened by Smith to be drawn on by Jones, it is a trust account. But if it means an account belonging to Smith consisting of money brought in by Jones, it would not.

Societies.—When a society's account is opened, the banker should be supplied with a copy of the resolution appointing the persons, who are authorised to operate on the account. When an advance is granted to the Committee of an Association, or to a club, a society or any similar body, an arrangement should be made whereby some one is rendered liable to repay the money, as otherwise the banker will be without any means of receiving the debt, as such bodies, not being incorporated, cannot be sued for the money.

Liquidators.—A liquidator is appointed by the Court to wind up the affairs of a company, to realise the company's assets and disburse the same amongst the shareholders and sundry creditors of the company. He has authority to raise advances on the security of the company's assets and to draw, sign cheques and bills of exchange and for the performance of these duties the liquidator will not be incurring any personal liability.

Bankrupts.—When a customer is adjudicated a bankrupt, his property vests in the official Receiver, or in Presidency towns in the Official Assignee who will administer the estate for the benefit of the creditors. Special care should be taken in respect of dealings with an undischarged bankrupt, for, according to law, he cannot obtain credit for more than Rs. 50/-.

Fixed Deposit Receipt

Fixed Deposit Receipts are not negotiable instruments like cheques or bills which are transferable by endorsement. These receipts are non-transferable and cannot pass title by endorsements in blank (Abdul Rahman Haji Asman *vs*. Central Bank of India and others).

Cheques are not drawn against fixed deposits as is the practice with banks. If the return of the deposit recepit is made a condition for payment, no cause of action will arise until its return.

If the deposit has been renewed, the period ot limitation will run from the date of maturity of the said receipt.

A deposit receipt may be the subject of a *donatio mortis causa.*

Fixed deposits may be received by banks in joint names. While receiving such deposits clear instructions should be taken as to whether money is payable to either or survivor. Accord-ing to the English law, a payment to any of the joint-holders gives a complete discharge (Wallace *vs*. Kelgall). In various decisions awarded by Indian Courts, it is observed that the decision in Wallace *vs*. Kelgall has no application in India.

According to Sir. John Paget, the deposit receipt "represents the money deposited, but to the banker, is a debt or chose in action assignable like any other debt or chose in action, independent of the receipt despite any restriction on the transferability of the receipt". While any deposit money is sought to be assigned in favour of a third party, it is the rule for the account holder to address a letter to the bank authoris-ing the third party to receive payment of the money and to deliver the deposit receipt properly discharged under revenue stamp on the back. The third party, in order to make his position safe, should serve that letter of authority upon the bank.

Some banks issue deposit receipts with the form of a cheque on the back thereof. Those receipts may then be treated as ordinary cheques.

Often the banks are approached for loans against their own fixed deposits. Though the banks are not bound legally to repay the deposit money before maturity, nor to grant any loan there-against, still to oblige the customers, if the banks feel it a necessity to grant loans against fixed deposit receipts occasionally, it is advisable for the banks to get the fixed deposit receipts duly discharged on the bank under revenue stamp and to get a letter of charge signed by them authorising banks to adjust the proceeds against indebtedness. But such loans against fixed deposits should be discouraged in times of emergency. Here it will be pertinent to quote a circular from the Reserve Bank of India on this point.

> "In connection with the measures to be taken by banks in emergencies, we would also invite their attention to our circular letter No. ACD. BS. 744/77-40 dated the 31st July, 1940, in which we requested them not to allow parties who have made fixed or time deposits to withdraw them in advance of the due date. We mentioned in that circular that if a client is, for any reason, in urgent need of money, it ought to be possible to give him an advance against the security of the time deposits. We should like to supplement this suggestion by stating that such advances may be granted by banks only during normal times and not in emergencies when banks should not only cease making fresh advances but should be recalling old ones. In our opinion, the distinction between "demand liabilities" and "time liabilities" is important and has been given statutory recognition in the Reserve Bank of India Act, which provides for the maintenance by the scheduled banks with the Reserve Bank of a lower percentage of cash against the latter, and repayment of time deposits before the due date amounts to converting them into demand deposits and tends to defeat the object of the above statutory provision. Besides, a distinction should be made between urgent and non-urgent needs of bank constituents, and since in emergencies when there is a scramble for cash, it will be very difficult to distinguish between *bona fide* urgent needs and others for advances against time deposits, we should be glad if banks would refuse to grant such advances during emergencies."

Distinction of a Joint-Family Firm from a Partnership Firm

1. A joint-family firm, unlike a partnership firm, is not dissolved on the death of one of the joint owners, nor can a partner of a joint-family firm, ask for an account of past losses and profits, should he choose to voluntarily sever his connection.
2. The 'karta' of a family only and not others, can create charge on the assets of the family for legal necessity.
3. If outsiders join such a joint-family firm, it ceases to be governed by the Hindu law and instead is governed by the Indian Partnership Act.

Account of a Family Firm.—When such an account is opened, the manager or 'karta' of the family should state clearly whether it is an ancestral family business or a new business. In the case of the latter it is to be declared whether there is any outsider as a partner. Cheques should always be signed by the manager or 'karta' of the family, as he alone possesses necessary authority.

Some Points to be Remembered by a Banker

1. When once a banker has opened an account, he has not the right to close the account without a reasonable notice to his customer of his intention to do so (Prosperity Ltd. *vs.* Lloyds Bank Ltd.).
2. A banker may often be asked to tender advice on the purchase or sale of securities. In so advising he should exercise all normal prudence, as in the event of his advice proving detrimental, the customer may hold the banker responsible for any loss he may sustain as a result of the banker's advice (Banbury *vs.* Bank of Montreal).
3. There are cases when a banker becomes trustee for his customer.
   (*a*) Where a third party remitted a certain amount to a banker for credit of an account, and this sum could not be appropriated to the proper account, and where the bank wrote to the remitter or to his own customer as to which of his accounts, if more than one, this

sum should be appropriated, it was held that the banker was a trustee (Official Assignee of Madras *vs.* D. Rajarane Aiyer).

(*b*) When a certain balance in a current account was earmarked for the purchase of securities and this purchase had not been completed, the balance of amount which lay in current or deposit account earmarked for such purchase was held by the banker in the capacity of a Trustee (Official Assignee of Madras *vs.* J. W. Irwin).

(*c*) Where, however, a customer asked the banker to purchase certain securities out of funds available in his current account and the banker failed before effecting the purchase, it was held that the banker was not a trustee for the amount so earmarked (Official Assignee of Madras case).

The Pass Book

The pass book contains the record of transactions in debits and credits, that have passed through the account of a client with the bank. Naturally such a book enables a client to check up his accounts to his satisfaction and to find out any discrepancy. Should any discrepancy be detected on examination of the pass book entries, that can be rectified by immediately bringing it to the notice of the bank. A specimen form of the pass book is given below, wherefrom some idea may be formed as to what is meant by a pass book.

D. K BARUA, Esq.,
in account with A. B Bank Ltd.

Date	Particulars of Deposits or Withdrawals	Dr. Rs. As P.	Signature	Cr. Rs As. P.	Balance

From the above form it is possible to get a complete picture of the deposits and withdrawals in a client's account. Under the head 'Particulars' are shown the deposits (marked 'by') and withdrawals (marked 'to'). The deposits are shown on the credit side (noted Cr.) and withdrawals entered under item debit (Dr.) and the balance is shown after adjustments of debits and credits.

Statements of Accounts.—But with the introduction of loose-leaf ledgers and the mechanisation of banking accounts, the pass books are gradually being replaced by statements of accounts which are daily or periodically sent to customers as agreed upon. But still certain sections of customers prefer the pass books to loose statements of accounts, because of the convenience of handling bound books containing the consolidated statements of the position of accounts, especially in connection with income-tax matters. A specimen form of such loose statement of account is given below:

P. C BARUA, Esq.,
in account with A. B. Bank Ltd.

Date	Particulars	Withdrawals	Deposits	Cr. or Dr.	Balance

At the bottom of such a statement the following is printed:

> "Unless this bank is immediately notified of any discrepancy found in the statement of account it will be taken *that the account has been found to be correct.*"

While sending such loose-leaf statements of accounts, certain banks attach a slip on which the customer is asked to acknowledge that the balance stated therein is correct, but the customer is under no duty to comply with it. At least it will prevent a customer from saying that he had no notice of the position of his account and that he did not get the pass book completed by the bank in time. In the case of a pass book, there is 'passing to and fro', *i.e.*, from the bank to the customer and from the customer to the bank, whereas statements are never returned to the bank.

Pass Book an Authentic Record

According to Sir John Paget, the proper function of a pass book is "to constitute a conclusive, unquestionable record of the transactions between banker and customer, and it should be recognised as such". But unfortunately the position of the pass book is most unsatisfactory. The legal decisions differ on this issue and as a result the position is far from clear. According to Sir John Paget, after full opportunity of examination on the part of the customer, all entries, at least to his debit, ought to be final and not liable to be reopened subsequently, at any rate to the detriment of the banker. But it will be risky to act on such a view about the pass book having regard to the conflicting legal decisions. In the case of Kepitigalla

Rubber Estates Co. *vs.* National Bank of India (1909) 2 K.B. 1010, it has been held that the mere taking out of the pass book and its return without objection will not constitute a settled account between the banker and his customer. But if a pass book of a certain business firm is returned to the bank after ticking the entries in debits and credits, there is a *prima facie* evidence that the entries have been found to be correct and the account is settled.

Examination of Pass Book Enjoined as Duty on the part of a Customer in the U.S.A.—But in the U.S.A. the matter has been more judiciously dealt with in a manner which will satisfy all reasonableness. In the case, Morgan *vs.* United States Mortgage and Trust Co. (1913), 208, New York Rep. 218, it has been held by the learned judge that "the depositor who sends his pass book to be written up and receives it back with his paid cheques as vouchers is bound to examine the pass book and vouchers and to report to the bank without unreasonable delay any errors which may be discovered...." Thereby it has been made obligatory on a customer to examine his pass book and check the entries therein. But it should not be missed that in the above case decision has been awarded on the basis of the fact that the paid cheques accompanied the pass book, but it is difficult to say whether the same decision would have remained unaltered had not the paid cheques accompanied the pass book.

Entries Favourable to a Customer.—Suppose an entry is erroneously made by a bank in favour of one of its customers, what will happen then? Here the answer will depend upon the nature of circumstances under which such an erroneous entry has been made by the bank. If a bank has, through mistake, entered in the pass book an uncleared cheque as cash deposit, it can get the mistake rectified by showing the real nature of the transaction. But if it wrongly credits to a customer's account more than due to him and the customer, relying upon the accuracy of the pass book entries of the said credits, draws cheques thereon in good faith, the banker cannot refuse his cheques without liability to pay damages for wrongful dishonour of cheques (Holland *vs.* Manchester and Liverpool District Banking Co. Ltd., 1904). So a banker is to be meticulously careful about the correctness of the entries to be made in the pass book, in order to safeguard his own interests. Mr. Sheldon is of the opinion that it will not be easy,

as a general rule, for an ordinary business man to establish his *bona fides* of drawing upon the wrong entry but in the case of an officer in the army who is accustomed to draw against moneys paid direct into his account with the army agents it is conceivable that he might draw upon such wrong credit entry in good faith, which he would otherwise have not done. So the deciding factor is the establishing of *bona fides* in such cases.

Entries Favourable to a Banker.—As regards entries favourable from a banker's standpoint there is no unanimity of opinion, nor a settled conclusion. The correctness of such entries cannot be challenged by a customer only when it can be proved beyond doubt that the customer himself was guilty of such negilgence as to cause banker's position to be prejudicially affected or must have acted in a manner which furnishes clear proof of the acceptance of the account as conclusively settled. But what amounts to a sufficient degree of negligence and what constitutes a settled account, remain still undefined. On the whole, the position has been summed up by Mr. Sheldon as follows: "Just as the law, even in its present state as regards the pass book, would not sanction any attempt of the customer fraudulently to take advantage of an error in his pass book to the banker's detriment, neither would it allow the banker to withhold money which he had received for a customer, even though the customer may not have pointed out the omission in his pass book."

Conclusion.—When the legal decisions on the pass book entries are conflicting and there is a dispute as to whether the pass book constitutes a settled account between the banker and the customer, it should be the duty of a banker to take particular care in correctly making the entries and to get the pass book made up-to-date and returned to the customer as frequently as possible by keeping notes thereof in the ledger. Any incorrect entry should be rectified by the bank without loss of time and the same should be promptly brought to the notice of the customer. Similarly, a customer, though not legally bound, should consider it his duty to verify the correctness of the entries made in the pass book and take the earliest opportunity to notify any discrepancy to the bank. Mutual co-operation and understanding between the customer and a banker in this regard may help to remove the present unsatisfactory position of the issue.

CHAPTER XIII

BILLS OF EXCHANGE AND LETTERS OF CREDIT

A BANKER should remember that the protection given under section 131 of the Negotiable Instruments Act does not extend to bills. So he should take care that the person, on whose behalf a bill is to be collected by him, has not a defective title to the bill. If it transpires that the title to the bill is defective, the collecting banker will have to refund the money to the true owner and the banker, in his turn, may look to his customer for the recovery of the same.

Acceptance.—If a bill is not already accepted, a banker is often called upon by his customer to present the bill for acceptance by the drawee. Section 61 of the Negotiable Instruments Act lays down the following procedure regarding presentment of bills for acceptance:—

> A bill of exchange payable after sight must, if no time or place is specified therein for presentment, be presented to the drawee thereof for acceptance, if he can, after reasonable search, be found, by a person entitled to demand acceptance, within a reasonable time after it is drawn, and in business hours on a business day. In default of such presentment, no party thereto is liable thereon to the person making such default.
>
> If the drawee cannot, after reasonable search, be found, the bill is dishonoured.
>
> If the bill is directed to the drawee at a particular place, it must be presented at that place; and if at the due date for presentment he cannot, after reasonable search, be found there, the bill is dishonoured.
>
> Where authorised by agreement or usage, a presentment through the post office by means of a registered letter is sufficient.

The banker should lose no time in presenting the bill for acceptance. By acceptance a banker is assured of an additional security

as the drawee in that case becomes liable along with others. In case a bill is payable after sight, the sooner it is presented for acceptance, the earlier will it mature for payment. It is held that a bill should be presented for acceptance within a reasonable time which is incapable of exact definition. That will be determined with reference to the nature of the bill and the usual course of dealing with such instruments. If there occurs delay in presentment due to circumstances beyond control, that may be excusable. The collecting banker should always guard against any negligence or misconduct on his part.

Acceptance may be on the face or back of the bill. Acceptance should be like ordinary endorsement, free from courtesy titles etc. The date of presentment for acceptance should be noted thereon. (In the case of aftersight bill, the date of sighting should be inserted.) If the bill is not accepted, the fact of non-acceptance should at once be notified to the customer.

A banker must not take a conditional acceptance without the consent of his principal, lest he should incur liability for acting contrary to instructions.

Presentment for acceptance is not necessary in the following cases:—

(a) Where the bill is payable on demand.

(b) Where the drawee is either a fictitious person, dead, insane, or bankrupt, or a person having no capacity to make contracts by bills.

(c) Where, in spite of reasonable diligence being applied by the banker, presentment cannot be effected.

(d) Where the drawee refuses to accept the bill on some ground.

Presentment for Payment.—Section 64 of the Negotiable Instruments Act lays down the procedure of presentment for payment:—

> Promissory notes, bills of exchange and cheques must be presented for payment to the maker, acceptor, or drawee thereof respectively, by or on behalf of the holder as hereinafter provided. In default of such presentment the other parties thereto are not liable thereon to such holder.
>
> Where authorised by agreement or usage, a presentment, through the post office by means of a registered letter is sufficient.

PROCEDURE OF PRESENTMENT OF BILLS

1. Presentment must be on the due date.
2. Where payable on demand, presentment must be made within a reasonable period, on a business day within business hours.
3. Presentment to be made at the place where it is payable.
4. When a bill is presented at the specified place and none authorised to pay or refuse is found, no further presentment need be made.
5. In the case of two or more acceptors, who are not partners, and where no place of payment is specified, presentment is to be made to all of them.
6. When the acceptor is dead and no place of payment is mentioned, presentment is to be made to a personal representative of the deceased.
7. When partial payment is made of a bill, the bill should not be left with the drawee, but notice of dishonour should be sent intimating that part payment has been made and not in full.

"At Sight", "On Presentment", "After Sight".—If any bill of exchange contains any such expression "at sight", "on presentment", it means that the bill is payable on demand and if it bears such expression "after sight" it means after acceptance, or noting for non-acceptance, or protest for non-acceptance.

MATURITY OF BILL OR NOTE

Section 23.—"In calculating the date at which a promissory note or bill of exchange, made payable a stated number of months after date or after sight, or after a certain event, is at maturity, the period stated shall be held to terminate on the day of the month which corresponds with the day on which the instrument is dated, or presented for acceptance or sight, or noted for non-acceptance, or protested for non-acceptance, or the event happens, or where the instrument is a bill of exchange made payable a stated number of months after sight and has been accepted for honour, with

the day on which it was so accepted. If the month in which the period would terminate has no corresponding day, the period shall be held to terminate on the last day of such month."

Illustrations :—

(*a*) A Negotiable instrument, dated 29th January, 1878, is made payable one month after date. The instrument is at maturity on the third day after 28th February, 1878.

(*b*) A Negotiable instrument, dated 30th August, 1878, is made payable three months after date. The instrument is at maturity on the 3rd December, 1878.

(*c*) A promissory note or bill of exchange, dated 31st August, 1878, is made payable three months after date. The instrument is at maturity on the 3rd December, 1878.

Noting and Protesting.—According to local usage an inland bill is not required to be noted if it is dishonoured but a foreign bill is to be protested in case of its dishonour.

Notice of Dishonour.—If a bill of exchange is dishonoured the bill is to be returned to the customer who deposited it with the bank for collection. But if the banker becomes a holder of the bill for value, he should at once notify the customer of the dishonour and demand repayment of the money.

Some eight excellent pieces of advice have been given with regard to bills of exchange in Pitman's Bills, Cheques and Notes:—

1. Never draw or accept an accommodation bill, unless you are prepared to meet it whenever called upon.
2. When a bill has been drawn by you, endeavour to secure its acceptance before negotiating it.
3. Unless you are to be personally liable in the bill, take care that any signature you place upon it, whether as drawer, acceptor, or endorser, shows clearly that you are signing in a representative capacity.
4. Never endorse a bill without receiving value for it.
5. Never discount a bill for a stranger. Be sure that you know the person from whom you receive a bill and take care that he endorses it.
6. Examine the bill carefully.

7. If you are the holder, present the bill for acceptance, if it has not been accepted, and for payment at the proper time. If either acceptance or payment is refused, give notice at once to every endorser and to the drawer, so as to hold each and all liable for payment.

8. Upon payment of a bill take care that you get the document into your own possession.

Parties to a Bill.—The person giving the order in a bill is called the "drawer". The person to whom the order is addressed is called the "drawee" and the person to whom or to whose order, the money is to be paid, is called the "payee". When the drawee accepts the bill by writing his name across it, he becomes the "acceptor". A bill may be negotiated like a cheque by endorsement.

A "holder" of the bill is the person in actual or constructive possession of the bill and is entitled under law to recover its contents from the parties to it.

A "holder in due course" is a holder who has taken a bill, complete and regular on the face of it, before it was overdue, and without notice of dishonour and in good faith and for value, and without notice when the bill was negotiated to him of any defect in the title of the person who negotiated it.

A "referee in the case of need" is a person whose name has been written on the bill by the drawer or an endorser and to whom the holder may resort in case of dishonour by non-acceptance or non-payment.

An "acceptor for honour" is the person not already liable on the bill who, with the holder's consent, accepts it after protest for the honour of any party liable thereon, or for the honour of the person for whose account the bill is drawn.

Illustrations.—Written across the bill like "accepted for honour of A. Sd/B" ; maturity is calculated from the date of the noting for non-acceptance, and not from the date of the acceptance for honour in England ; but in India it is calculated from the date of acceptance.

A "payer for honour" is the person who pays a bill after protest for the honour of any party liable thereon, or for the honour of the person for whose account the bill is drawn.

Date of Bill and Calculation of Due Dates

A bill may be ante-dated, post-dated or dated on a holiday. The omission of a date does not invalidate a bill. If the holder in good faith puts a wrong date through inadvertence, that date will be considered as the true date.

When a bill is not payable on demand, three days' grace is added to the period of payment, unless otherwise stipulated in the bill, and the bill is payable on the last date of grace. When a bill is payable on a certain date fixed, no days of grace are allowed.

Examples.—When the last day of grace is Sunday and January 1 and January 2 are bank holidays in England, the bill is payable on the 3rd January but in India it will be payable on the 30th December as 31st December is a holiday in India.

The term "month" means a calendar month. (Bill 30th April payable at one month—30th May and 3 days' grace—2nd June)

A bill payable after sight but accepted in the manner "sighted 1st May, accepted 2nd May", the time will run from the sighting date and not from the acceptance date. If a bill is noted or protested, the period will run from the date of noting or protesting. Bills payable in the middle of January or middle of February will mature on 18th January or February (15 + 3) including three days' grace.

When the last day of grace is a Sunday, Christmas Day, Good Friday, *i.e.*, any public holiday, the bill becomes due on the preceding day. But when in England the last day of grace is a *bank holiday* (other than Christmas day or Good Friday) or when the last day of grace is a Sunday and the second day of grace is a bank holiday, *the bill becomes due on the succeeding business day.* But in India there is no such distinction between bank holiday and other holidays. Here the bill is payable on the preceding business day.

Material Alterations.—Material alterations relate to alterations of date, amount, time of payment, place of payment and where a bill has been accepted, generally the addition of a place of payment without the acceptor's consent. Any material alteration of a bill without all parties' consent discharges those, who are no parties to the alteration, but not those, who are parties to it.

Negotiation of Bills

A bill of exchange may be payable to order or to bearer. A bill payable to a specified person becomes payable to any one person at his order. A bill prohibiting its transfer becomes a non-negotiable instrument. A bill which becomes overdue can be negotiated subject to any defect in its title after maturity and in that case a person acquiring such an overdue bill cannot pass a better title than that which the person from whom he took it had. A transferor by delivery cannot escape liability if there is a prior forgery.

Noting and Protesting

A bill is noted to create official evidence as to the dishonour of the instrument. In each case the bill is taken to the Notary Public, who represents it for payment and on refusal the bill is noted. Noting is a minute made on a dishonoured bill or on a slip of paper attached to the bill, by the notary public, containing the date of presentment, notary's charges, a reference to the notary's register, and his initials. This noting is supported by a formal document bearing notary public's seal attesting the fact that the bill has been dishonoured. The protest requires a copy of the bill, notary's seal, the name of the person for whom the bill is protested, the place and date of protest, the cause or reason for protesting etc.

Discounting of Bills

Bill discounting is a lucrative source of investment for a bank. The bank can be sure of the repayment of the money on the maturity of the bill, which is usually drawn for a short period, and as such the bills constitute the liquid assets of a bank, which are convertible into cash within a short time. Besides this, the bills are free from fluctuations in prices, as compared with stock-exchange securities and provide a higher yield than advances or loans, as the bank, by discounting, not only earns the discount and collection charges but also interest so long as the bills remain unpaid. Moreover, bill business brings the bank into contact with

a larger circle of clientele, who may then be persuaded to open their accounts with the bank for better facilities.

The following precautionary measures should be adopted by a bank before discounting any bill:—

1. The credit of the party whose bill is to be discounted must be ascertained to warrant safety. If the party is solvent and commands good credit, his proposal may be considered. Once satisfied about the credit of the party, the credit, means and integrity of the acceptor or drawee should also be inquired into.
2. The banker must then examine whether the bill is genuine and covers consignments of marketable goods. It is to be distinguished from accommodation bills, which are not supported by any goods, and where the drawer and the drawee of the bills are the same parties. Accommodation bills should not be discounted for the sake of safety.
3. The bill must be completed and must be free from defects.
4. It is to be examined that the bills are properly stamped in conformity with the provisions of the Indian Stamp Act. Bills in India were previously required to be stamped @ -/2/- per thousand.

Accommodation Bills

The above type of bills is of the nature of "kite-flying". In most cases the drawer and the drawee happen to be the same parties. When the bill matures for payment, the drawer discounts another bill with the bank and sends the proceeds thereof by drafts or telegraphic transfers to the drawee, who on receipt thereof, honours that bill. In this manner, the operations continue unchecked in a circle, from one point to another, from one direction to another. On the failure of some firms it is later on detected that these cyclic operations went on unnoticed. If a party can enjoy credit from several banks, such kinds of "accommodation" operations or kite-flying can be carried on by him undetected for a considerably long time; because he can easily meet his obligations with the bank credits. So a bank manager should exercise strict vigilance and shrewd alertness to find out the nature of such operations. He

should gather information from the market as to whether the drawer is really sending goods to the drawee in respect of the bills he purchases.

HAWALA BILLS

The above forms of bills are in vogue in Malabar. The word "hawala" means advice or information. These bills were like sight bills with this distinction that there is a note thereon stating that they would be paid a week or a fortnight after date. Originally this was done to avoid stamp duty. But generally these bills degenerated into accommodation bills. Being "sight bills" they were not accepted and so the drawees did not incur any liability.

SHROFFI BILLS

The above bills had usance for a period varying between two and six months and represented genuine credit operations. The shroff, while making advances to his borrower, would take from the latter a bill drawn in his favour, which he would endorse to the bank and obtain from it, in his turn, financial accommodation. Here the liability of the shroff will arise only in default of payment by the borrower. The shroff here acts as a shock-absorber between the borrower and the banker.

POINTS TO BE EXAMINED

1. Sight bills require no stamping, while usance bills are to be stamped according to law.
2. Bills drawn in foreign countries and payable in India should be stamped with Indian bill stamps as soon as they reach India.
3. It is to be examined whether the bill complies with the provisions of the Negotiable Instruments Act. If the wordings of the bill do not come within such definition of the bill as is given in the Negotiable Instruments Act, the holder may lose protection.
4. It is to be examined whether the bill is dead or alive.

HUNDIS

Hundis written in vernacular do not usually fall in the category of negotiable instruments and instead of being governed by the Negotiable Instruments Act, are rather governed by local usages, unless the writing thereon indicates an intention that the legal relations of the parties thereto should be governed by the Negotiable Instruments Act. They are of two kinds, *viz.*, (*a*) the Shah Joghi hundis and (*b*) the Jokhmi hundis.

Shah Joghi Hundis.—The Shah Joghi hundis are ordinarily drawn for the purpose of remittances. The drawee of the hundi is, in such a case, asked to pay it to a "Shah", *i.e.*, a respectable holder after making proper inquiry. It usually states the name of the persons on whose account the hundi is drawn. So long as the drawee makes payment of the hundi to the right person, he can recover the money from the drawer. But if payment is made by the drawee to a Shah who obtains the hundi by forged endorsement, the drawee remains liable to the true owner of the hundi (Madhabdas Jathashi *vs.* Dindas Vardass 1934, Bom. L. R. 929). But for all practical purposes a *Shah Joghi* hundi is treated as a negotiable instrument independently of the provisions of the Negotiable Instruments Act.

Jokhmi Hundi.—A Jokhmi hundi is in the nature of a policy of insurance, with this difference that the money is paid beforehand, to be recovered if the ship is not lost. It is one kind of insuring the goods shipped. Here three parties are involved, namely, (*a*) the drawer, *i.e.*, the shipper, (*b*) the hundiwala, *i.e.*, the underwriter and (*c*) the malwala, *i.e.*, the consignee. Here the consignor draws hundi on the consignee, *i.e.*, malwala for the value of goods and sells them to the insurer for cash minus insurance premium. The hundiwala then presents the hundi to the malwala when the goods reach the destination safely. If the malwala or the consignee refuses payment, the hundiwala has no recourse against the consignee but then has to take up the matter with the consignor. If the ship is lost, the hundiwala has to bear the loss himself.

Dhanijog.—Such a hundi is payable to any holder, *i.e.*, the Dhani.

Darshani and Nadappu vaddi Hundis.—These are sight hundis

which are payable at sight and carry interest at the *nadappu vaddi* from the date of presentation.

Muddati Hundi.—This kind of hundi is not payable like a darshani hundi at sight but is payable according to usance or custom. Hundis payable to order are called *Firmanjog* Hundis.

Paith.—When the original hundi is lost, the duplicate that is issued is called the "Paith".

Letters of Credit

A Letter of Credit is a document issued by a banker authorising the banker to whom it is addressed, to honour the cheques of the person named in the document, to the extent of a certain sum stated in the letter and to charge the sums to the account of the grantor. The particulars of the cheques or drafts honoured by the banker should have to be filled in on the back of the letter of credit, so that it is possible to ascertain the extent of credit exhausted and the balance outstanding for further drawings. The letter of credit bears the period for which it is to remain in force, on the expiry of which it lapses until it is otherwise extended by the grantor.

Clean and Documentary Letters of Credit.—A letter of credit authorises the person, to whom it is addressed, to draw bills according to terms on the bank issuing it and is supported by a promise on the part of the issuing banker to accept all bills drawn up to the limit. When the promise to accept is conditional on the receipt of the documents of title to goods, like bill of lading, invoice, insurance policy, it is called a documentary letter of credit. It is *clean* when it is unconditional and has no reference to the documents of title.

Conditions of issuing such Letters:—

(*a*) It is to be examined whether the proposal is based on *bona fide* commercial transactions and also whether the party applying has good credit and reputation in the market.

(*b*) Goods to be covered by the letter of credit should be easily marketable. Goods which have no ready market should be rejected for the sake of safety.

(c) Certain percentage varying from 30% to 10% is to be demanded as margin to cover the transaction. The margin is demanded usually according to the nature of the commodities and the credit of the parties.

A Letter of Indication serves the purpose of identification of the person carrying it. Therein the signature of the person named in the letter is attested by the issuing banker.

Revocable and Irrevocable Credit.—A revocable letter of credit is one which can be cancelled at any time by the issuing banker but he will be liable if that bill is negotiated before its cancellation. Irrevocable credit is one which cannot be cancelled before the expiry of the period of its currency.

PRECAUTIONS TO BE TAKEN FOR NEGOTIATING A BILL UNDER LETTER OF CREDIT

1. It is to be satisfied that the letter of credit is genuine and bears the genuine signature of the issuing bank. A question may naturally arise in one's mind as to how it is possible for a bank in India to ascertain the genuineness of the signature of the issuing bank, if the latter happens to be a foreign bank outside India. In such a case, the letter of credit when opened is sent to the foreign bank's correspondent office in India which will certify its genuineness while forwarding it.
2. That the currency of the letter has not expired is to be examined.
3. The terms and conditions of the letter of credit should be carefully examined and the bill will have to be negotiated in conformity with those terms and conditions. Otherwise the issuing bank will be exempted from any kind of liability.
4. The identity of the party as indicated in the letter of credit will have to be established before negotiation of the bill. Usually such transactions being negotiated through banks, the identity of the person can be ascertained from his banker.

5. While negotiating a documentary bill, the banker usually gets a letter of hypothecation signed by the party in the bank's favour. On the strength of the letter of hypothecation, the bank has the right to take possession of the goods covered by the bill, in default of payment by the customer, and reimburse himself by selling those goods.
6. A letter of credit is either clean or documentary. In the case of clean credit the above mentioned precautions are sufficient for the purpose of negotiation. Examination of documents under documentary credits is more complicated and one is to be very careful to safeguard one's interest.

Broadly speaking, the credits stipulate submission of the undernoted documents in case of shipments to foreign countries.

1. Bill of Lading.
2. Commercial Invoice.
3. Certificates of origin and value.
4. Insurance Policy or Certificate.

Of these documents the bill of lading is the most important as it represents document of title to goods. So inspection of the documents should be thorough. The following points are to be borne in mind:

Signature of the Shipping Co's agents—cases of forged bill of lading have been reported and one is to be sure that the signature is genuine. Where it is not possible for the negotiating houses to keep specimen signatures of all the shipping agents in the port, one is to rely on the respectability of the party whose bill one negotiates. Of course, it is understood that the bankers opening credit cannot shirk responsibility for payment on a forged bill of lading if it is otherwise in order.

1. A bill of lading should be made out strictly in accordance with the terms of the credit. If the letter of credit stipulates "on board" bill of lading which means that the goods have been actually loaded on board the steamer, one is to see that this clause appears somewhere in the bill of lading. Sometimes bills of lading are issued with the clause "Received for shipment etc. . ." and unless credit stipulates acceptance of such clauses, these bills of lading

cannot be accepted. The description of the goods must conform to the terms of letter of credit. Endorsement of this document is also to be made in accordance with the letter of credit.

2. Commercial invoices stating particulars of shipment and cost thereof according to the letter of credit, or marks and numbers of the packages should be the same as those mentioned in the bill of lading. If any other instructions are to be followed in terms of the letter of credit, it must be seen that they are complied with.
3. *Certificate of origin and value.*—It is a form of declaration giving particulars of shipment and a certificate by an authorised person on behalf of the exporters as to the origin of the goods shipped. In accordance with customs regulation in some ports of destination, this certificate has to be countersigned by a recognised Chamber of Commerce.
4. *Policy of Insurance.*—These are documents evidencing that the goods have been covered by insurance against possible risks in transit. Here also, the terms of letter of credit are the guiding factor. In case where the letter of credit does not stipulate any particular risk to be covered, it is the duty of the negotiating banker to see that the goods are covered against usual marine, nowadays war, risks.

Revolving Credit.—If the credit is so worded that the amount for which it is available automatically reverts to the original amount, it is an instance of "revolving credit". Revolving credit may be of different types, *viz.*—

(*a*) Blank credit up to an unlimited amount ; but this type is rare.

(*b*) Such credit may be issued for an unlimited amount in total but with a stated limit to the amount of drafts that may remain outstanding. In such a case, a letter of credit is opened for a stated amount, say Rs. 10,000/- outstanding at any time. This means that drafts may be negotiated at a time up to Rs. 10,000/- but that amount is automatically reinstated as soon as the negotiated draft is paid.

(*c*) It may be for an unlimited amount but subject to such restriction of amount which may be drawn at any one time.

(*d*) Another form of revolving credit is for a limited amount which can be drawn within a given period, but is utilised up to the stipulated limit during the given period ; further drawings are not permissible until the new period begins. "A revolving credit is one for a certain sum which is automatically renewed by putting on at the bottom that which is taken off at the top."

Circular Letters of Credit.—Circular letters of credit are usually intended for the use of the travellers and tourists who require money in different parts of the globe they intend to visit. Such letters may be of two kinds, *viz.*, (*a*) traveller's letters of credit, and (*b*) guarantee letters of credit. A traveller's letter of credit carries the instructions of the issuing bank to its correspondent to pay the beneficiary's draft up to a stipulated amount, which will be debited to the customer's account and which the issuing bank undertakes and honours on presentation. While issuing a guarantee letter of credit, the bank secures a guarantee for reimbursement at an agreed rate of interest or insists on some security against the credit.

CHAPTER XIV

BANK ADVANCES

The quality of a banker's advances determines largely the soundness or otherwise of the bank. Safety, liquidity and profitability are the three primary considerations for a banker to formulate his advances policy. The fundamental principle of commercial banking is not to lock up funds for a long time, since the deposits of the bank are repayable on demand or within a specified period. So the advances of the bank must be made against such kinds of securities as are realisable quickly. Sufficient prudence is, therefore, to be exercised in selecting the right types of securities and the success of a banker lies, in a great measure, in making the right choice of assets. While making any advance a banker is to satisfy himself, apart from the consideration of the safety of the assets, of the borrower's respectability, business integrity and creditworthiness. Besides this, he is to ascertain the purpose of the advance applied for and also the source from which it is sought to be repaid.

The borrowing powers of the applicant must have to be carefully examined and scrutinised to the bank's satisfaction. If the applicant is a joint-stock company, the Memorandum and Articles of Association, as amended up-to-date and properly certified, will have to be examined and the Board's resolution obtained. If the borrower happens to be a partnership firm, a partnership declaration should be signed by all the partners and delivered to the bank. In the case of advances to the joint Hindu family, it is to be remembered that the 'karta' of the family is alone competent to borrow for family necessity. Advances to Trustees, Executors, Clubs or Associations should be avoided as far as practicable. No advances should be made to minors, who have no contractual capacity. Likewise no advances should be made to an agent on account of a principal without being satisfied as to the former's power-of-attorney and restrictions, if any.

While making advances, readily marketable securities should

be accepted and specially those which do not entail any violent fluctuations in their value. Then proper margin should be kept as safety cover. Next, it is of importance for a banker to see that the security belongs to the borrower who must have absolute right to pledge it. To enforce the right of sale, he is to get from the borrower signed Letter of Lien, Letter of Continuity and other such documents. A banker should bear in mind that advances should be diversified as far as possible to avoid risk.

Advances Against Government Securities

Government securities may take any of the following forms:

(1) Inscribed stock.
(2) Bearer Bonds.
(3) Promissory Notes.

An "Inscribed Stock" is so called as the name of the stock-holder is inscribed or recorded in the register kept in the Public Debt Office. Where stock is held in this form, the owner is given a certificate to the effect that he has been registered as the proprietor of a certain amount of Government stock. This is known as a stock certificate. The title to this stock does not pass by endorsement. It passes only when accompanied by a transfer deed duly executed. The execution of such transfer deeds does not involve any stamp duty and copies of such deeds are obtainable from the Public Debt Office. Another advantage of this form of stock is that interest is paid on warrants which are made payable at whatever Treasury or Sub-Treasury the owner of the stock desires without the production of the relative stock certificates.

Bearer Bonds are payable to bearer and their mere possession constitutes ownership like currency notes. Those bonds are transferable by mere delivery. This form of security suffers from a fundamental defect in that their loss deprives the owner of any right or title to it.

A banker is very often approached for granting advances on the security of Government Promissory Notes. From the standpoint of safety and liquidity, advances against such Government Promissory Notes are unquestionable. To regularise the advances

against Government securities some of the following measures are to be taken by a banker:

(a) It is to be examined at what place the interests of the Government Promissory Notes are payable. After ascertaining that place, care should be taken to send those securities to the Public Debt Office of that area for the purpose of renewal in the bank's name. A renewal fee of Re. 1/- is payable to the Public Debt Office in this connection. After the Government Promissory Notes are received back duly renewed in the bank's name, the advance should then be made. But as customers do not prefer to wait till renewal of the Government Promissory Notes, a banker is to resort to the alternative procedure. In such a case he sends the Government Promissory Notes to the Public Debt Office for the placing of the sale-power-stamp by the Public Debt Office on the endorsement-cage on payment of Rs. 2/. If the Public Debt Office find the endorsements in order, they put the sale-power-stamp, which signifies that the Government Promissory Notes will be renewed in the endorsee's name in due course without difficulty.

It is held that once the *Government Promissory* Notes are renewed in the name of the endorsee, the latter will have an undisputed claim and title to those notes. But the Privy Council decision in Secretary of State for India *vs.* Bank of India has upset this common belief, as it has been decided in that case that the endorsee will not have a better claim, even if the note is endorsed in his name, if it subsequently transpires that certain fraud took place in previous endorsements. But still the banker cannot claim better protection except by getting the notes renewed in his name.

(b) A certain percentage varying from 20% to 10% of the market value of those Government Promissory Notes is usually kept as margin against any short-fall that is likely to arise from fluctuations in the value of those securities.

(c) It is the usual practice of the market that at least two cages in the Government Promissory Notes should be left blank. Accordingly, a banker should see that at least there

are two cages left in the Government Promissory Notes when offered as securities.

(ii) When Government Promissory Notes are offered as securities by limited companies, a banker should see that the Notes are endorsed by persons having authority to do so supported by the proper resolution of the Board and that authority should have to be registered in the books of the Public Debt Office to facilitate the quick renewal. Further, a declaration in the following form should be taken from the appropriate authority so that the title of the bank may not be challenged by others.

DECLARATION OF OWNERSHIP OF SECURITIES

I/We do hereby declare that the securities mentioned hereunder, which we have lodged with you as security for advances being made or to be made to us by (Name of the borrower) absolutely belong to me/us and no other person has any claim, title or interest therein.
Schedule of securities
with particulars,

Signature of the Borrower.

ADVANCES AGAINST SHARES AND DEBENTURES

It is the policy of every bank to make advances against those shares only, which are in the bank's approved list. Those shares are selected after taking into consideration how far they are free from fluctuations in price, non-speculative in character and dividend-paying. A margin varying between 50% and 40% of the market value is kept and a banker constantly watches the market-quotations to guard against any fall in the stipulated margin. Partly-paid shares should not be accepted as a rule, because in that case the lending banker would have to incur the additional liability to pay up the further calls when made. Shares of private limited companies should be avoided because of the usual hindrances in their transferability. When a single share certificate covers large blocks of shares, the banker should examine its genuineness as a precautionary measure against attempts at fraud by the chang-

ing of numbers with the help of chemicals. For safety's sake, the bank will do well to get the shares, against which advances have been made, registered in its own name in the books of the company. The transfer deed should be completed with care and properly witnessed. Shares standing in the names of third parties, should not, as a rule, be accepted as securities in view of the legal complications involved, as in that case it would really amount to a virtual repledge of shares. The risk which a bank has to face in such a case was brought out in the case of Benares Bank Ltd., *vs.* Prem & Co., in the Allahabad High Court. Wherever possible, the banker should obtain a properly stamped Memorandum of deposit of shares.

There are occasions when a banker is to accept a blank transfer. Such blank transfers are fraught with certain risks. In Abdul Vahed Abdul Karim *vs.* Husanali Ghasia it has been laid down that the registered owner of shares by handing over share certificates with a blank transfer duly signed by him to another person, does not represent to the world that such a person is entitled to deal with the shares and therefore a *bona fide* purchaser from such a person does not acquire a good title to such shares. It is for this reason that the banker insists upon the production of the broker's bills in support of the shares, intended to be pledged as securities, so that if any defect in title to those shares is detected, the money can be recoverable from the brokers from whom those shares were purchased. Brokers here act as a second line of defence.

It often happens that the parties take delivery of shares directly from their brokers, who release those shares against cheques in anticipation of realisation together with the broker's bills discharged. Those who are unscrupulous and know full well that their cheques will not be honoured, taking advantage of such a situation, may like to pledge those shares with the bank, with a mischievous intent and obtain accommodation thereagainst from the bank, which might apparently consider the transaction regular on this assumption that the brokers are to deliver shares only when they receive payment and as such the bank cannot suspect any irregularity. The cheques, against which the shares were delivered, having been dishonoured, the brokers exercised vendor's lien on those shares for non-payment and claimed such securities from the bank. In some cases the bank had to part with those shares even though pledged with it as

securities. So the bank should use the utmost caution in such dealings. Preferably such dealings should be restricted to borrowers of unimpeachable credit only and to those whose honesty is unquestionable. Sometimes a bank is requested to discount bills covering delivery of shares on brokers. If such a proposal is entertained at all, the brokers commanding good credit in the market should alone be selected.

It is to be remembered that the deposit of share scrips with blank transfer confers upon a banker an equitable title to those securities, which may be defeated by prior equitable or subsequent legal title. A bank acquires equitable title to shares under the following circumstances:

1. By deposit of securities.
2. By deposit of securities with a Memorandum.
3. By deposit of securities with blank transfer.
4. By deposit of securities and execution of special power-of-attorney in favour of the banker authorising him to sell them in default in payment of the advance made to them.

In order to have an undisputed title, the bank must have the shares transferred in its own name. Thereby the bank gets the following advantages:

1. The bank will be free from any fear of a prior charge upon those shares.
2. In case the transferor has no right to pledge the shares, the company's notice of transfer, sent to the name and address of the registered shareholder, will usually cause the rightful owner to make inquiries which may bring to light any possible fraud.

There are disadvantages also of the shares being transferred in the bank's name or the names of its nominees. If the shares are partly paid-up, the bank may be liable to pay up the further calls if made. The procedure of registration is costly. Stamp charges and registration fees are to be incurred both on transfer and retransfer when the advance is made and repaid. It is not an absolute guarantee against fraud on the part of the pledger. If the bank's nominees die, it may involve much delay and trouble in getting the shares retransferred in the names of the bank's new nominees. The practice of having the shares transferred to the bank's nominess has been replaced, of late, by that of getting the

shares transferred into the names of nominee companies, incorporated principally for the purpose of such holding. This has an obvious advantage in that a company never dies. When a bank is to take any legal action in respect of securities held in the name of its nominee company, it is to be started in the name of the nominee company.

The advantages of taking security in the form of deposit of shares accompanied by a memorandum are as follows:

(*a*) It saves trouble if the advance is for a short period. If otherwise shares are held in the name of the bank or names of its nominees, they may have to be retransferred when the advance is repaid.

(*b*) Stamp duty on transfers is saved.

(*c*) Some restriction is usually placed on the transfer of the shares of private companies or the customer may be a director and as such be required to have a certain holding qualification when it may not be advisable to have the shares taken out of his name.

The chief risk in taking an equitable mortgage lies in the banker's equitable title being postponed to a prior equitable title, such as, trust. There are other drawbacks of such advances. For example, when the question of sale arises and the borrower fails to keep his undertaking to execute a transfer, the banker is faced with the costly and lengthy process of approaching the court for an order for sale. This difficulty is, however, obviated by taking a blank transfer.

A blank transfer is one where some material particulars regarding the transferee are lacking. The idea of taking a blank transfer is that if it so becomes necessary, the blanks may be filled in at a later date when the transfer will operate as a valid document. But this is permissible only in those cases where the mode for transfer is permitted to be by writing under hand. There are certain companies, however, whose articles lay down that their transfers must be by deed only. In such cases, since a deed to be valid must be complete at the time of delivery, a blank transfer is useless and should not be accepted. There is another risk in making advances against untransferred shares. There is the possibility of the customer obtaining a fresh certificate from the company by representing that he has lost the original certificates. In that case an

unscrupulous borrower may be selling the duplicate scrips issued by the company leaving the bank in difficulty when the latter comes to realise his security.

A banker may, however, insure against the above risks by serving a notice of lien on the company while taking untransferred shares as security. If a notice of lien is served, the banker will secure priority over any future advances the company may make to the shareholder, and secondly, it will prevent any fraudulent dealing with the share on the part of the holder. In Bradford Banking Co. *vs.* Biggs, where according to the Articles of Association of a limited company, the company was to have its first and paramount lien on its shares for non-payment of calls, etc. and where a shareholder had pledged his shares against a loan by deposit of share scrip and blank transfer with the bank and the bank had given due notice of such deposit to the company issuing those shares and the shareholder became subsequently indebted to the company, it was held that the company having notice of the deposit of the share scrip with the bank could not enforce its lien for the debt incurred subsequent to the notice. Even though some of the companies do not take any notice of such communication, it is advisable still to send such notice preferably under registered post in duplicate. Although the companies which reserve the right to exercise lien on their shares send back the notice, they, as a matter of practice, take note of the bank's charge elsewhere, and if a transfer is subsequently lodged by some one other than the bank, they usually inform the bank when the latter may, by injunction, restrain the shareholder concerned from fraudulently dealing with the shares. Similarly, when the shares are released, the notice withdrawing the bank's charge on them may be sent to the company concerned.

A banker can safeguard his interest by serving a notice in lieu of Distringas. The object of such notice is that a person having an equitable interest in certain shares may prevent the registered shareholder from dealing with these shares in an adverse way. The claimant may move the court to issue a notice in lieu of Distringas. In terms of this notice, the company will be called upon to refrain from registering the transfer of shares or from paying dividends on the same to the registered shareholder without, in the first instance, notifying the claimant of the proposed registration or payment of dividend. The company, when it intends to deal

with the shares in any way, will give eight days' notice of its intention to the claimant and if the latter does not take such steps as he considers necessary to protect his interest as, for instance, obtaining an injunction of the Court, the Distringas will cease to operate and the company may lawfully proceed to carry out the shareholder's request for transfer of the shares and payment of the dividend. In practice, such a course is not adopted unless the bank has obtained a judgment or is about to sue the borrower or has reason to think that he will try to dispose of the shares and misapply the grounds.

Shares standing in the names of third parties should not, as a rule, be taken as security unless accompanied by an appropriate letter from the third party agreeing to the shares being pledged to the bank and giving his own rights and interest in favour of the borrower. In this letter the third party should expressly declare that he has relinquished his right, interest, title or claim of any kind over the shares in question and that they have been handed over to the borrower with blank transfer as and by way of sale. As a rule, the banker should insist on the borrower getting the shares transferred to his name or to the bank's name. The bank should take care not to accept shares standing in the names of minors as security for advances.

Advances against the repledge of shares are risky and should be avoided as far as practicable.

Debentures

Simple debentures are those where no security is given for payment of interest or repayment of the principal.

Mortgage debentures are those which are secured on the company's property giving a charge upon the whole or a part of the assets.

Bearer debentures are those payable to bearer with or without power for the borrower to have them placed on a register or to have them at any time withdrawn from it. These are transferable by delivery.

Registered debentures are payable to a registered holder. Any transfer of these must be registered with the company. Mortgage debentures may create a fixed or floating charge. The fixed charge creates a mortgage on some specific property of the company in

favour of the debenture holders. This is usually done by a Trust deed by which a specific part of the property vests in trustees.

A floating charge means that the holder of the debenture has a right to be paid out of the assets of the company and the property mortgaged comprises freeholds, leaseholds such as stock, book debts, etc. A floating charge attaches to the assets in the varying condition they may happen to be from time to time and remains dormant so long as the company is a going concern and so long as the charge does not become fixed.

A specific charge is one that without move fastens on ascertained and specific property or properties capable of being ascertained and defined ; a floating charge on the other hand is ambulatory, shifting in its nature hovering over and so to speak, floating with the property which it is intended to affect until some event occurs or some act is done which causes it to settle and fasten on the subject of charge within its reach and grasp. The floating charge becomes fixed when the company defaults in paying interest or goes into liquidation.

Debentures are better than shares as they generally create a charge on some of the assets of the company and, in any case, will rank before the shares at the time of distribution of assets in the event of the company's liquidation. Their yield being fixed, they are less liable to fluctuations in price than shares. It is necessary to see that the company has power by its memorandum and articles of association to issue debentures and that such power has not been exceeded. It is also necessary to see how these debentures are secured. Where a debenture is offered as a security, the deeds of property should be deposited with the banker along with the debenture. Otherwise an equitable mortgage without notice of the debenture might obtain priority. In such cases a bank usually takes two documents. *viz.*, the debenture itself and a form of agreement which is supplemental to the debenture and is executed by the company at the same time. The agreement links up to the debenture with the bank's advance and sets out the particulars of the arrangement as between the company and the bank vis-a-vis the debenture. It is, however, unusual for a bank to sell the company's debenture on which it has advanced money. More often than not, the lending bank enforces his remedy by the appointment of a receiver under the debenture trust deed and

it is the receiver who sells the undertaking either piecemeal or as a whole.

There are two types of debentures, *viz.*, fixed sum debentures and 'all money' debentures. A fixed sum debenture will either be a single investment or a series of debentures making up the total sum lent. The advantage of this type over an 'all money' debenture is said to be that it would be possible to sell the debenture as opposed to selling the assets charged thereunder. It is considered that with a fixed sum debenture it might be looked upon as an investment by the bank, thus limiting the bank's right to that of an ordinary debenture-holder.

An 'all money' debenture probably appeals more to a company than a fixed debenture plus a memorandum of agreement. It is not capable of sale and hence the company knows that it can have only the bank to reckon with. Then the registration of a fixed sum debenture means publishing a figure which may never be read with deterimental effect on the company's creditors. The registration of 'all money' debenture issued to the bank leaves the general body of the company's creditors guessing. It is probably less detrimental to credit than the registration of particulars of a debenture for a fixed amount. Another advantage of a debenture for 'all moneys' due and owing is that if the company's business expands or warrants an increased limit for advances by the bank there is no occasion for a fresh agreement or further issue of debentures All that is necessary is to increase the stamp duty on the existing debenture, check the borrowing power of the company and obtain a proper resolution covering the increased advances. When there is a debenture for a fixed amount, further debenture and agreement are required to provide for further advances. The following points should be remembered in connection with advances against debentures:—

1 (*a*) Are the debentures issued at a discount or at par?

(*b*) Is the interest either normal or excessive? Both these will indicate the credit of the concern.

2. The date of the redemption of debentures.

3. (*a*) What are the assets charged and does their value afford sufficient cover and leave a reasonable margin beside? The extent of cover afforded to debentures can be estimated by taking into account the assets charged.

(b) What is the nature of the charge—fixed or floating?

(c) Are there prior issues? Where a series of debentures exists each rank in the order of its issue and it is obvious that the value of the security will be diminishing with each further issue. The rank will be indicated on the balance sheet *i.e.* 1st mortgage, 2nd mortgage, etc.

(d) Is there a collateral issue?

(e) Is there any uncalled share capital and is it charged?

4. (a) Are there any arrears of debenture interest and are they brought into account on the balance sheet?

(b) What are the prospects of regular payment? A fairly accurate estimate can be made of these by reference to a record of these payments in the past, the means and standing of the firm as disclosed by its working capital and if during the period in which regular payments were affected business was normal.

5. Are funds being accumulated periodically and invested outside the business to ensure redemption in the normal course? This can be judged by referring to the specific investments in the balance sheet, generally the Redemption Reserve Fund Investment Account.

ADVANCES AGAINST LIFE POLICIES

J. W. Gilbert in his "The Logic of Banking" advises that a banker should never make advances upon life policies. The reasons for the unpopularity of such advances are given below:—

1. A non-disclosure of a material fact to the insurance company may vitiate the contract of the life policy and as a result, the security of the bank is likely to be prejudiced. To remove its defect section 45 of the Insurance Act, 1938, provides that no insurance policy shall be disputed after it has been in force for two years from the date of the policy or on the ground of any misrepresentation alleged to have been made to defraud the company.
2. The policy may lapse owing to the failure of the policy-holder to pay premiums in time. So the banker is to see that the policy is kept alive.
3. The law relating to priority of assignments is unsatisfactory. In India priority of assignment is determined not

by the date of the registration of the assignment but by the actual date of the assignment. So a policy-holder should give such a declaration to the banker that a policy is free from any prior charge or encumbrances.

4. Complications in payment of the policy may arise in case of suicide.
5. Any person may effect a policy provided he has an insurable interest in the life to be insured. Absence of insurable interest will make the policy void. There is much dispute as to who can have insurable interest and it may complicate the issue and so affect the security.

Precautionary Measures to be Adopted

The following precautionary measures should be adopted by a banker while making advances on the security of life policies:—

1. Only the policies issued by the companies of undoubted integrity and solvency should be accepted.
2. Endowment policies having a fixed maturity should be accepted in preference to 'whole life policies'.
3. The banker should be satisfied that there exists an insurable interest in the life of the assured.
4. The policy much accrue surrender-value and the banker should not advance more than 80% to 90% of the surrender-value.
5. The policy should be assigned by the assured in favour of the bank and the assignment thereof should be registered in the books of the company along with a notice of assignment, supported by a fee of Re. 1 as provided in section 38 of the Insurance Act in India.
6. It is to be examined by the banker that the age is admitted by the Company so that no delay may arise while making payment of the policy when due.
7. The banker should always see that the policy does not lapse by non-payment of premia. In fact, he should insist on the latest premium receipts being surrendered to him so that he may ascertain whether the policy is in force or not.

8. Advances should not be made against industrial, educational policies or short-time policies or policies issued before the 1st July, 1939 or under section 6 of the Married Women's Property Act, 1874.

ADVANCES AGAINST IMMOVABLE PROPERTIES

Advances against immovable properties involve many legal formalities and are not favoured by ordinary commercial banks. Such advances should be made only to parties whose capacity for prompt repayment is undoubted. Preferably monthly or quarterly instalments should be stipulated for repayment of the advance and the advance should not be allowed to remain outstanding for more than one year or so.

While granting advances against properties to a Hindu constituent, it is to be ascertained whether the advance is to be made to him in his individual capacity or as the 'karta' of a joint Hindu family. If it is to be made in the individual capacity, a declaration should be taken as to whether the property is self-acquired or ancestral. As according to the 'Mitakshara' law of inheritance every co-parcener of a joint Hindu-family has the right to mortgage his own undivided share in the property, which is liable to changes by reason of birth or death, advances should never be made against a member's undivided share in the joint family property. If the advance is to be made to the 'karta' of the family, the legal necessity for the advance is to be proved beyond doubt. Advances should never be made against a property of which the borrower is a part-owner, for it is so difficult to partition the property and enforce specific security.

A stamped declaration of absolute ownership, verified by an independent enquiry, should be obtained from the borrower affirming that the property is free from encumbrances, litigation, adverse claims and has not been served with any notice by the municipality and the like for acquisition, encroachment or repairs.

If the property is lease-hold, the total period of the lease and the unexpired period should be ascertained. As the date of expiry of the lease approaches, the value of the property tends to diminish.

The terms of the lease should be carefully studied. Sometimes there remain certain clauses which require the condition of obtaining

prior consent of the lessor to effect any transfer. The bank should see that in such a case the written permission of the lessor is taken. Receipts for payment of ground rent and other such charges should be examined and kept in files.

The property should be valued by a competent surveyor and an adequate margin should be kept against the advance. The situation, nature of the locality and current price of adjoining properties should also be taken into consideration. The property should be kept insured against all risks.

The title of the borrower to the property should have to be established beyond dispute before a banker accepts such property as a security for advance. It is necessary to make a search in the Registration office to find out whether there was any prior charge. In the case of investigation of title the banker should make certain that the receipts or discharges endorsed on the prior mortgage deeds relating to the property are duly registered, for unregistered discharges are not readily recognised by courts.

Advances against immovable properties may be made either in the form of a legal mortgage or an equitable mortgage by deposit of title deed. Equitable mortgage is permissible only in some specified towns. In such a case of equitable mortgage a letter on the following lines should be taken from the borrower:

> "I have deposited the title deed of my premises.........with an intent to create security against my overdraft account with the Bank."

And the deposit of title deed should be recorded in the bank's Security Register. An equitable mortgage of a property outside the specified towns is possible by the delivery of its title deed to the bank in a town, where equitable mortgage is permissible.

The following precautions should be taken by a banker in respect of advances against immovable properties:

(*a*) Advances should be made against properties, if so required for genuine trade purposes, after the banker is satisfied that the borrower is capable of repaying his dues within a reasonable time, say, one year.

(*b*) As far as possible it should be stipulated that the advance should be repaid by regular monthly or quarterly instalments and care should be taken to see that the instalments are regularly paid without default or postponement.

(*c*) It is necessary to make sure that the intending mortgagor is a person of full age and that he is legally entitled to dispose of the property.

(*d*) The advance must of necessity be restricted to the mortgage value of the property which may usually be placed at one-third of the sale value of the property.

(*e*) If a property is of a specialised character and the banker cannot be satisfied that the mortgage could readily be arranged with the result that any advance could not readily be liquidated, then there would be a violation of one of the canons of sound banking and the advance should not be made.

Besides an equitable mortgage there may be a legal mortgage. A legal mortgage gives the banker rights against a property itself quite apart from any personal action against the borrower. The banker gets what is called a legal estate in the property and acquires all rights and remedies which can for the most part be exercised on his own without seeking the intervention of the court. An equitable mortgage however does not offer such a right. It only gives a personal right against its owner, a right to participate in the proceeds of the property when sold and a right to enforce the claim by invoking the aid of a law court. Further, should any liability attach to the property charged, the legal mortgagee may become responsible for due performance whereas an equitable mortgagee would escape such liability. Finally, an equitable mortgage on redemption needs no reconveyance to the mortgagor while a legal mortgage remains after redemption as a definite link in the chain of title and must be discharged by the giving of a receipt for the mortgage money usually on the back of the form of mortgage to extinguish the mortgage term.

A simple mortgage represents a transaction in which the mortgagor without delivering possession of the mortgaged property binds himself personally to pay the mortgage money and agrees expressly or impliedly that in the event of his failure to pay according to the terms of contract the mortgagee shall have a right to cause the mortgaged property to be sold and the proceeds of sale applied in payment of the mortgage money. Here sale cannot be made without the order of the court. So in order to enforce his security a banker would in such cases have first to get a decree directing sale of the mortgaged property. A simple mortgage must

invariably be registered whatever be the value of the property. The reason is that a simple mortgage amounts to sale of an intangible right to immovable property to the mortgagee and the sale of intangible property requires registration even if the value is below Rs. 100. A banker in such cases does not acquire his right of foreclosure.

A mortgage by conditional sale represents a transaction in which the mortgagor sells a mortgaged property on the conditions mentioned below:

(*a*) that in default of payment of the mortgage money on a certain date the sale becomes absolute but (*b*) on such payment being made the same shall become void and (*c*) the buyer shall reconvey the property to the seller. In this form of mortgage delivery of possession is not made to the mortgagee and the property remains with the mortgagor.

Again there is no personal liability on the part of the mortgagor to pay the debt as in simple mortgage. The essential characteristic of this form of mortgage is that on default of the payment, the transaction is closed and the property becomes the absolute property of the mortgagee.

In a usufructuary mortgage, the mortgagor delivers possession of the mortgaged property to the mortgagee and authorises him to have such possession until payment of the mortgage money and to receive the rents and profits accrued from the property with a view to appropriating them in payment of the mortgage money. Where the mortgagor fails to deliver possession to the mortgagee there is no usufructuary mortgage.

The essential ingredients of an English mortgage are as follows:—

(*i*) The mortgagor should bind himself to repay the mortgage money on a certain date.

(*ii*) The property mortgaged should be absolutely transferred to the mortgagee.

(*iii*) Such absolute transfer should be made subject to the proviso that the mortgagee will reconvey the property to the mortgagor upon payment by him of the mortgage money on the fixed date.

Both in a simple mortgage and English mortgage the mortgagor incurs a personal liability to repay and the mortgagee

can sue for realisation of his dues either by a sale of the mortgaged property or by personal action. But a simple mortgage differs from an English mortgage in that in the latter case the property charged is transferred absolutely to the mortgagee but in a simple mortgage only the right to sell is transferred while the property remains with the mortgagor. Moreover, an English mortgagee has the right to sell without the intervention of the court but a simple mortgagee has not.

ADVANCES AGAINST GOODS

In earlier times advances against the pledge of goods in a godown were not looked upon with favour. Gradually, such advances have attained much popularity and are considered free from risks. As most of these advances are of a seasonal character, they are recommended as safe from the banker's standpoint as well. Besides this, such advances facilitate the flow of trade and commerce to a great extent.

Though such advances possess certain advantages, still they are not always free from risks. To make such advances requires specialised knowledge, wide experience and constant vigilance. Moreover, goods have certain inherent defects as securities for a banker. *Firstly*, storage of such goods, more particularly in a country like India, is a big problem, inasmuch as these goods are stored mostly in village hats, pits and kuccha godowns, sometimes in loose condition and sometimes in bags. *Secondly*, there is the difficulty of an accurate verification and valuation of stocks due to multiplicity of weights and measures of units of sale in different parts of the country. *Thirdly*, produce is not standardised or properly graded and is not always of a uniform quality. *Fourthly*, there is a lack of organised markets in India, where the produce can be disposed of at short notice. *Fifthly*, commodity prices depend not merely on demand and supply but on transport and marketing facilities, which are so much restricted within the countryside. *Sixthly*, the bankers are to adopt extra precautionary measures for the protection of the commodities against deterioration in quality and quantity, fire, theft, etc.

In spite of these difficulties, the Indian banks have made godown-advances an important part of their business and have

handled such advances, in most cases, in a safe manner. As regards the selection of the commodities against which advances are sought to be made, a banker is to make enquiry about the purpose and period of advance, and is to satisfy himself of the easy marketability of the commodities. The easy saleability of the products in the open market and the steadiness of the demand for those products are essential considerations for a banker, which will largely influence his decision to fix the *margin*. It is needless to say that the business integrity, honesty and credit of the intending borrower are decisive factors for the grant of an advance.

After the banker takes a decision to make advances against goods on weighing different considerations, he will first of all take possession of the goods. Since storage facilities are not well-organised in India in the absence of proper warehouses a banker is to arrange for their storage, with such modifications and adjustments as are feasible in the existing circumstances. Usually, the raw agricultural produce is stored loose in the first instance. Produce like paddy, wheat, etc. is sometimes stored underground in *pits*, which are crudely dug out in open yards and closed with hay, leaves and clay, etc. Banks usually make advances against produce stored in those pits, provided they are fenced round and have gateways which are kept under lock by the bank. At the time of storage, the bank's representative remains present to count the stocks. Sometimes the produce is stored in villages in what are known as "Kothas", "Gadis" or "Paris" and the banks take possession of those goods by tying a string or rope round the structures and displaying their sign-boards in a prominent place. It is very easy to take delivery of goods stored in a well-constructed pucca warehouse, which is often found in certain areas. Produce stored in bags helps counting and weighing. Commodities like kappas, *i.e.*, cotton before ginning, cotton, juggery (gur), copra do not, by their very nature, permit of accurate verification of quantity by counting. In such cases weighment is the only practical means for verification and no hard and fast rule can, in this regard, be laid down. The contents may be examined by taking out samples at random. Once the quantity in a godown is ascertained and possession taken of the goods, valuation can be made with reference to the current market rates. When the market value of the stocks is calculated, the question of fixing the margin comes

up for consideration. In fixing the margin the credit of the borrower is taken into consideration. A borrower with good credit in the market may succeed in negotiating a low margin. Next, the nature of the commodity and the extent of its saleability are to be considered. Usually, a lower margin may be fixed for commodities like rice, wheat, cotton, etc. commanding a steady demand and easy marketability while a higher margin is demanded of commodities like coffee, mica, etc. which possess restricted marketability. As regards commodities like tobacco, having numerous variations, and lacking in proper gradation and standardization, a very high percentage of margin may be deemed to be insufficient. After the godown-keeper of the bank certifies that the contents have been examined and verified and possession taken thereof, by placing the bank's padlock thereon, the bank gets the necessary documents executed by the borrower and makes the advance. It is needless to say that the safety of such advances depends virtually on the honesty and integrity and sense of responsibility of the godown-keeper and his constant vigilance over the stocks.

Banks always insist on insurance of the goods against the risks of fire, burglary, flood and riot, etc. and the costs of insurance are payable by the borrowers. Banks sometimes permit part-delivery of commodities, and the delivery of goods to borrowers or their authorised agents is permitted by delivery orders issued by the officials of the banks to their respective godown-keepers. These orders are marked "non-transferable" and must bear the discharge of the borrowers on the back before goods are delivered to them. Later on those should be properly filed. Usually the following books are maintained in connection with advances against goods:—

1. Securities Register—wherein all documents are entered.
2. Produce Loan Ledger—where advances are shown as individual loan and separately entered.
3. Liability Ledger—the total liability of the borrower, directly or indirectly, is shown in the ledger on any given date.
4. Stock Book—wherein the details of the goods lodged and delivered from time to time are noted.
5. Inspection Register—wherein full details of the godowns, their localities and the dates of periodical inspections are entered.

6. Insurance Register—wherein the policies covering the goods are entered with full particulars.
7. Key Register—banks get manufactured padlocks with their names engraved thereon and with serial numbers both on the back and the corresponding keys in duplicate. To keep their proper account a register is maintained.

Safeguarding the Security:—

1. The banker must have an unquestionable possession of the goods and must exercise thereon absolute control in such a manner that no third party can challenge the title of the bank or plead ignorance of the bank's possession. The bank's own locks and keys bearing names in addition to its sign-board are evidence of the fact of pledge and of the bank being the pledgee.
2. Keys of the godown should be kept by the bank in safe custody. There have been instances where keys were obtained by borrowers on false pretences and goods were removed and sold out and there have been instances where the same goods were pledged to another bank by merely handing over the keys.
3. Stocks should be inspected periodically. It is to be examined whether the godowns are safely situated and are properly constructed and are not surrounded by inflammable materials. It is to be noted that there are no other doors to the godown.
4. Specialised knowledge is required in the selection of the goods and also in the determination of their quality.
5. The fluctuation of the commodity prices should be carefully watched and margin should be called up if it shrinks due to a fall in the market value under notice to the borrower.
6. It is to be seen that stocks are released during the season and must not be allowed to stay overlong.
7. Whenever the security is to be enforced for the adjustment of the indebtedness, it should be disposed of, preferably by public auction which means due publicity of the time, place, and conditions in newspapers or by handbills.
8. Goods must be insured for their full value. All material

information relating to the goods and godowns should be furnished on proper examination to the company for insurance. Special note should be taken of the terms of the policies with regard to the description of the property insured and it is to be guarded that there should arise no such circumstances as may vitiate the claim, if any, especially that more hazardous goods than those in the policy should not be stored and that nothing is kept near about to increase the risk of fire.

Advances Against Pledge of Manufactured Goods

Advances against manufactured goods involve certain problems somewhat different from those against agricultural produce. In a raw condition the produce being capable of being put to various uses, enjoys a wider marketability. But as soon as it is turned into a manufactured output, it has a limited market. So in such cases the personal credit of the borrower is a more important factor than the security itself. The borrower must possess specialised knowledge and experience in the line of manufactured goods, as those are to pass through different stages and processes. From the banker's standpoint the manufactured goods have certain advantages over the agricultural products. *Firstly*, the manufactured goods are easily portable, usually well-packed and of uniform quality in general. So those can be stored with lesser difficulty. *Secondly*, advances against manufactured goods have a longer duration than agricultural produce, which is seasonal in character, and may continue throughout the year yielding a steady return to the bank. *Thirdly*, manufactured goods being stored mostly in big sea-ports and manufacturing centres, it is possible for a banker to handle these operations more easily, as in such places facilities for clearing and storing goods and for auction sales are well-organised. Still such advantages are not free from risks. Manufactured goods have numerous varieties and it is not certain when they will reach the ultimate consumers, as they are held up long in the process of distribution. Standard goods have a steady demand but fancy goods a seasonal one.

Manufactured goods, especially those imported from foreign countries, are supported by invoices, wherefrom the goods can be

easily identified and the contents ascertained. Those invoices should be produced before banks at the time of making advances and be carefully examined to find out any discrepancy or flaw. The marks, and numbers of cases are noted in the invoice and should be scrutinised. The banker should select standard goods only as securities.

Produce Under Hypothecation

Hypothecation implies that the possession and property in the goods remain with the borrower and only an equitable charge is created in favour of the lender. The charge of the bank may be overridden in case of the attachment of the goods by another creditor or insolvency of the borrower or if the goods are pledged to a third party having no notice of the hypothecation to bankers. Consequently advances against the hypothecation of produce are fraught with great risks. Still such types of business are growing in volume and are often taken up to accommodate business men of established reputation. Generally, advances are made against hypothecation if the goods cannot be kept under the bank's lock and key, because of the fluctuations in the incomings and outgoings of the stocks and in such cases a floating charge is created in favour of the bank on the entire assets of the business undertaking. If such a charge is created by a limited company, private or public, it has to be registered with the Registrar of Joint-Stock Companies, which fact serves as a notice to the public of the bank's interest in the goods.

In the case of hypothecation, stocks cannot be verified except by a rough and ready method. In regard to such advances the banker is to rely, to a great extent, on the honesty of the borrower and is to satisfy himself with a stock-list as supplied periodically by the borrower. The following precautionary measures should be taken to safeguard the securities and the bank's interests:

1. As the goods are hypothecated to the bank, the bank's sign-board is to be displayed prominently. But on many occasions borrowers do not like this sort of publicity.
2. A godown-keeper should be engaged to keep an account, if possible, of the incomings and outgoings of stocks
3. Frequent inspection should be made from time to time.

4. Stocks should be kept fully insured against all risks. The bank has its prescribed specimen of document of hypothecation, whereby the interests and claim of the bank are sought to be safeguarded in all possible ways.

ADVANCES AGAINST DOCUMENTS OF TITLE TO GOODS

The following are principal documents of title to goods:—

1. Bills of Lading.
2. Dock Warrants.
3. Warehouse Keeper's Certificate.
4. Delivery Orders.
5. Railway Receipts.

Bills of Lading—A bill of lading represents a receipt for goods upon shipment, signed by some person authorised to sign the same on behalf of the shipowner. The document states that the goods have been shipped in good order, and quotes the rate at which the freight is to be paid by the consignees. A note is usually put on a bill of lading that the weight, quantity and quality of the cargo are not known. The shipowner undertakes to deliver the goods at the destination in the same condition as they were when he received them.

Bills of lading are usually drawn in sets of three, each one stamped, and in addition, there are two copies. Of these copies one is retained by the master and the other is handed over to the loading brokers. The copies are of no value. To avoid the loss in transit, one set is sent by one mail and another by the following mail, while the third set is kept by the shipper.

Distinction between bill of exchange and bill of lading :—

1. A bill of exchange is negotiable, while a bill of lading is not. If a bill of exchange payable to order and duly endorsed is stolen, the party taking it in good faith and for valuable consideration, acquires a good title to it. But the same will not happen in the case of a bill of lading.
2. According to Sir John Paget, the only exceptional feature akin to negotiability possessed by bills of lading is their acknowledged capacity to defeat the unpaid vendor's right of stoppage in transition when transferred with authority to *bona fide* transferee for value.

But if the consignee desires to transfer the goods to someone else, he can do so by endorsing the bill of lading in the latter's favour, who by delivering the said bill of lading, may be the owner of those goods. If the consignee's name is not stated in the bill of lading, the ownership of the goods remains with the consignor. When the goods received on board are in good condition and no adverse comments are made on the bill of lading about the quality or package of those goods, it is called *a clean bill of lading*.

With regard to the three parts of a bill of lading Earl Cairns made in the case of Glyn and Co. some observations which are worth remembering:—

> "All that any person who advances money upon a bill of lading will have to do, if he sees, as he will see on the face of the bill of lading, that it has been signed in more parts than one, will be to require that all the parts are brought in. If the person advancing the money does not choose to do that, another course which he may take is, to be vigilant and on the alert, and to take care that he is on the spot at the first arrival of the ship in the dock."

Often does the consignor draw a bill of exchange upon the consignee for the value of the goods despatched and attach the bills of lading to the bill, send the same through his banker to the consignee for acceptance with instructions sometimes to deliver the bill to the consignee on acceptance so that he may meet his acceptance on maturity by the sale proceeds of those goods.

Copies of the Bill of Lading are sometimes marked 'Copy—not negotiable' to ensure that no confusion shall arise between the unsigned copies and the valid parts. One of the three stamped Bills of Lading is sent by the shipper to the consignee by one mail, and another is sent by another route, if possible, or by the following mail, and the third is retained by the shipper as evidence in support of a claim for insurance in the event of the ship being lost, that the goods were in that ship. On the arrival of the ship at its destination, the consignee may, by showing the Bill of Lading to the Master of the ship and paying all claim for freight and other charges, obtain possession of the goods. If the consignee wishes to transfer the goods to some other person, he can, by simply endors-

ing the Bill of Lading and delivering it to that person, constitute him the absolute owner of the goods.

When it is recorded in the documents that the relative goods have been shipped on board it is known as an on board Bill of Lading or shipped Bill of Lading. It is issued by the ship-owners when the goods are actually received on board the vessel.

Some Bills of Lading state merely that the goods have been received for shipment and when they are so worded, they are not regarded with favour by the lending bankers as security.

There is another type of Bill of Lading known as 'Through Bill of Lading'. It is issued to exporters when transhipment of the goods is to be made during transit and before their delivery at the port of destination, It is generally a combination of a Railway Receipt as well as a bill of Lading and provides for the continuous responsibility of several railway companies and shipping companies from one place to another. Attached to the original 'Through' Bill of Lading' there must always be a validation certificate. The validation certificate is issued by the rail-road company and certifies that the official who signed the Bill of Lading is the agent of the company and is authorised to sign. A rubber stamp bearing the name of the rail-road company is impressed partly on the validation certificate and partly on the Bill of Lading and all marks and numbers appearing on the validation certificate must be identical with those on the Bill of Lading which must be signed by the individual mentioned in the validation certificate.

A straight Bill of Lading specifies that the goods are consigned to a particular and specified person. The goods are not consigned to that person or order or assigns and property in the goods does not pass by endorsement.

General Precautions:

1. The banker must be satisfied of the customers' business integrity and financial standing before discounting the bills of lading.
2. In order to ascertain the contents of packages, the banker should depute a representative to supervise packing.
3. All the sets of the bill of lading should be secured.
4. It is to be examined whether the bill of lading contains any onerous clause, such as "all conditions of every character

as charter party", reserving to the owners of the vessel the right of lien upon the cargo for payment of freight, demurrage and other charges.

5. It will be in the interest of the banker to get the bill of lading endorsed in blank by the consignee, in which case the responsibility for paying the freight will fall upon the customer and not on the banker.
6. The banker should get the insurance policies covering the specified goods, instead of open policies.
7. Besides these, the banker should get from the borrower a general stamped letter of hypothecation executed, by virtue of which he may take possession of the goods in case the bill is not paid.
8. If a banker is to part with any bill of lading before receiving payment from the customer, he may do so on execution of a stamped Trust Receipt. But this course is also fraught with great risks and may not protect a bank in case the borrower, in breach of trust, pledges those bills with some other banks, which then acquire a legal title to the goods, in good faith and without notice (The Chartered Bank of India *vs.* the Imperial Bank of India, I.L.R. 60, Cal. 1262). So Trust Receipts in such cases are valueless.

Railway Receipts (*R/R*).—In the case of advances against Railway Receipts it should be remembered that the pledge of the Railway Receipts is not equivalent to a pledge of the goods covered by them. It is necessary, therefore, to take a letter of lien from the borrower specially creating a charge on goods in transit. As the Railway Companies do not testify to the quality or nature of the goods received, there is some risk involved in this business and it should, therefore, be confined to first class parties. In the Railway Receipts, either the bank or the borrower should be mentioned as the consignee, and in the latter case the borrower should duly endorse the receipts either in blank or in favour of the bank. It should also be seen whether the freight has been fully prepaid. The terms of the Railway Company's risk notes should also be studied carefully. The banker should examine the Railway Receipts in detail as in the body of the Railway Receipts the number of the packages, the nature of goods and the approximate

weight are mentioned. The date of the Railway Receipts should be examined carefully. It is safe to insist on invoices accompanying the bills. The bank's rubber-stamp should be affixed on the Railway Receipts to prevent any subsequent misuse. Cases happen when duplicate Railway Receipts are obtained from the Railway Companies on executing an indemnity bond and the goods may be taken delivery of on production of the duplicate Railway Receipts. So the banker, in such cases, will do well to notify the Railway Company of his lien over the goods. In Mercantile Bank of India Ltd. *vs*. Central Bank of India the Privy Council decided the competing claims of two banks over goods covered by Railway Receipts. There the Central Bank of India financed a merchant against the security of a Railway Receipt, when the former delivered to the latter for releasing the goods and storing the same in the bank's godown. The said merchant misused the same Receipt for raising a second loan from the Mercantile Bank, which took delivery of the goods. The case was decided in favour of the Central Bank on the ground that the Central Bank of India owed no duty to the Mercantile Bank to adopt precautionary measures against the misuse of the Railway Receipt by the borrowing merchant, who cannot, in this case, transfer a better title than he possessed—a title subject to the pledge to the Central Bank of India Ltd.

The following precautions should be observed while making advances against Railway Receipts:

1. The invoice detailing the goods covered by the R/R is attached.
2. The invoice is duly signed by the party or his duly authorised agent.
3. Rates in the invoice do not exceed the market rates of the goods.
4. Description and rate of the goods tally with the R/R.
5. The R/R has been issued from the station where the bill originates.
6. The goods are consigned at the Railway's risk and not at the owner's risk. If the owner's risk R/R is accepted, it is to be ensured that the goods are insured for door to door delivery.
7. Railway freight has been paid on the R/R.

8. The R/R is endorsed in favour of the bank or its order by the person named as consignee in the R/R.
9. The Railway Receipt is clean *i.e.*, free from adverse remarks *e.g.* (*a*) goods badly packed, (*b*) goods liable to breakage, etc.
10. The R/R contains a clear description of the goods consigned.
11. The weight of the goods as stated in the R/R nearly equals the value of the goods consigned and agrees with the invoice.
12. There is no alteration either of the number of articles consigned or of the weight.
13. It should be carefully examined that the R/R is genuine.
14. The R/R does not bear the rubber stamp of any other bank. Where it does, it should not be accepted as the rubber stamp of another bank indicates its previous return as an unpaid item.

Dock Warrants.—A dock warrant is a document issued by a dock company stating that the goods as described therein are entered in its books and are deliverable to the person mentioned or his assigns by endorsement.

The warrants when given as security should be endorsed by the person named, and be accompanied by a Memorandum of deposit or letter of lien. The Memorandum should give the bank authority, in the event of default of repayment, to sell the goods and out of the proceeds to repay the loan. The Memorandum should also provide for insurance of the goods against fire, etc.

Warehouse-Keeper's Certificates.—A warehouse-keeper's certificate represents a document issued by a warehouse-keeper stating that certain goods are held in the warehouse at the disposal of the person named. Such a certificate or receipt is not transferable and the goods are not deliverable on its production. It is simply an acknowledgment of receipt of certain goods.

When the owner wishes to take delivery of the goods he signs a delivery order or may obtain a warehouse warrant stating that the goods are deliverable to the person named therein or to his assigns by endorsement. If the banker desires to grant any advance against the security of the warehouse-keeper's receipts, he should get the certificate issued in the bank's name. Otherwise, in

the event of the borrower's bankruptcy, the property will vest in the trustee in bankruptcy.

Delivery Orders.—A delivery order is a document containing the owner's instructions respecting delivery, addressed to the proprietors of the warehouse where the goods are lodged. The owner fills in the name of the person, either himself or his assign, who is authorised to receive the goods. The document is not required to be stamped. A banker making advances against the security of the delivery order should, for safety's sake, get the goods registered in his name under advice to the warehouse-keeper. Otherwise, his claim may be defeated on the bankruptcy of the customer, as in that case the property will vest in the trustee in bankruptcy.

Bonded Warehouse Certificates.—These certificates are obtained by people who expect to reship the goods and who wish to defer paying customs duty until the relative goods are sold out or are actually required for trading purposes. When the customer approaches a bank for an advance against a certificate of the bonded warehouse in his own name the lending bank exercises special care, because the bank through which the documents were received would have granted the required accommodation if the business were safe. In any case the certificate should be transferred in the name of the bank to make the bank's title absolute. Usually an advance on such certificates is not allowed to run for more than a few months at the most. If the manufactured goods are not sold out within a short time of their arrival and if the importer does not have the means even to pay the duty and keep the goods elsewhere than in the bonded house, such a state is construed as a reflection on the financial position of the borrower.

Some baling presses issue certificates like warehouse-keeper's certificates. Cotton, jute, yarn etc. are taken to the press for bailing. In the meantime the owners of the goods authorise the press-owners to hold them under lien to the bank and they issue certificates accordingly. On the back of the certificates the receipts and deliveries are marked and the outstanding stocks confirmed periodically. So long as the press-owners are respectable and possess business integrity, banks advance on the security of such certificates.

Sometimes banks are found advancing against receipts granted by the owners of country boats, which are often to carry a heavy

cargo and merchandise. These are called Varinames issued by the boat-owners. But in most cases, they deliver the goods according to the terms of the receipts. These receipts have no legal recognition and the bank will have no resourse if the goods are wrongly delivered.

Advances Against Miscellaneous Securities

Gold ornaments.—

Advances against gold ornaments are not self-liquidating as is the case with advances against goods and very often banks have to put pressure for the recovery of such advances. Even then, in many cases, realisation has been effected either by sale of the ornaments or by the repledge of the security with another bank. Such advances usually come up for renewal over again. In Northern India, specially in the Punjab, some gold ornaments like bangles, are made hollow with lac inside. In such cases it is difficult to measure the exact gold contents. It is the practice among banks to have the ornaments assayed by a professional goldsmith or jeweller who guarantees the genuineness of the articles. In the majority of cases, the borrowers are male members while it is found that most of the ornaments against which advances are sought are those of feminine wear. This may give rise to the possibility of the female member claiming the ornaments as 'stridhan' property and repudiating the borrowers' right to pledge the same. The following precautionary measures should, however, be taken while making such advances:

(*i*) A stamped declaration should be taken from the borrower that the ornaments are his own property and that he has the absolute right to pledge them.

(*ii*) Advances against the repledge of gold ornaments should be avoided as far as possible. If such advances are to be made, they should be confined only to respectable money-lenders.

(*iii*) Gold ornaments should be valued at market rates.

(*iv*) A margin between 15% and 20% should be maintained on the value.

(*v*) Ornaments studded with precious stones should not normally be accepted as security.

(*vi*) Gold ornaments should be weighed and appraised carefully.

(*vii*) Advances against gold ornaments should not be allowed to run indefinitely but should be repaid within a year or so.

(*viii*) Advances should be made for a limited amount say, Rs. 5,000, to a single party.

Bank's own Fixed Deposits:

Where loans are granted to clients against the bank's fixed deposit receipts, the latter should be duly discharged and the bank authorised to note its lien on the deposit receipt and credit the proceeds on maturity to the loan account. If the fixed deposit receipt stands in the names of two or more persons jointly, the loan documents should be signed by all of them. In case the fixed deposit stands in the names of two or more persons and is payable to either or survivor, no advance should be made against that receipt to one of the parties without the written consent of both or all of them. Either they should all sign the documents or there should be a letter signed by all authorising the applicant to raise the loan. If the deposit receipt is issued in the name of a third party, the fixed deposit receipt duly discharged by the depositor should be obtained. In addition, a letter authorising the bank to allow the loan to the person specified, on the security of the fixed deposit receipt and adjust the loan from the proceeds on maturity should be taken from the depositor.

Advances against fixed deposit receipts standing in the names of minors should not normally be made.

When a fixed deposit receipt is accepted as security, lien should be noted against the relative entry in the Fixed Deposit Ledger as well as in the Fixed Deposit Register under the initial of the bank's official. A margin of 5 to 10 per cent should normally be maintained.

National Savings Certificates:

These certificates are issued for a specified period. The interest accruing on such certificates is free of income-tax. While such certificates rank as first class investments, they are not acceptable as security because they are not transferable. It is

provided in the rules that the transfer of certificates as security to private individuals, banks, etc. is prohibited. Moreover, the terms of issue provide that no claim by any person holding the certificates in respect of loans will be recognised by Government. This precludes the banker from obtaining a valid charge over these certificates. The banker may, however, obtain some protection by having the certificates deposited with the official form of request for repayment signed in blank by the owner of the certificates. If it becomes necessary to realise the certificates, the bank's name will be filled in and the official form forwarded to the Post Master General when the proceeds, if still available, will be paid over to the bank. But the risk to the bank in allowing advances against such certificates cannot be minimised.

Government Supply Bills:

Payments by Government of contract moneys are made from time to time as the works proceed against certificates given by the officers concerned. During the last war bankers lent freely against assignment of such Government supply bills. But it must be remembered that such advances are not secured and are not backed by any tangible security. Advances against supply bills should usually be made to first class parties only. The following precautions should be adopted while making such advances:

(*i*) A power-of-attorney should be executed by the contractor customer in favour of the bank and registered with the particular department of the Government.

(*ii*) Each bill must be discharged by the contractor with the words 'Received payment' under appropriate stamp and the bill should be made payable to the bank by a separate endorsement as provided in the standard bill form itself.

(*iii*) Such bills are usually drawn in triplicate and all should be discharged and endorsed likewise.

(*iv*) The bills should be accompanied with the relative inspection notes certifying approval, acceptance and receipt of the goods mentioned therein.

(*v*) The banker should verify the rates charged in the bills from the acceptance note under which the particular contract was accepted.

(*vi*) Along with each bill, the letter of the contractor addressed to the appropriate Government authority authorising him to make payment of the bill to the bank direct should be sent.

(*vii*) It is not advisable to treat bills of certain Government departments *viz.* M.E.S., C.P.W.D. as supply bills and allow advances against them.

(*viii*) Where a bill is not paid by the Government within a reasonable time, the amount of the bill should be immediately recovered from the customer and the bill allowed to stand on the customer's account.

Guarantee and Indemnity

Definition.—A contract of guarantee is defined under section 126 of the Indian Contract Act, 1872, as "a contract to perform the promise, or discharge the liability, of a third person in case of his default". A guarantee may be oral or written in India. But in England a guarantee must always be in writing. In case of a guarantee three parties are involved, namely, principal debtor, creditor, and the surety.

Contract of Indemnity.—Section 124 of the Indian Contract Act defines a contract of indemnity as "a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person."

When the consignee of some goods wants to take delivery of the same from the railway authorities without the production of the Railway Receipts, he is required to give an indemnity bond undertaking to compensate the railway authorities for any loss they may suffer on account of the delivery of those without Railway Receipts.

Distinction between guarantee and indemnity:

1. In the case of a guarantee there exist two contracts, a principal contract between the borrower and the lender and a secondary contract between the lender and the surety. But in the case of an indemnity, there is only one primary contract.

2. In the case of a guarantee, the principal debtor is primarily responsible for the repayment of the money and the surety is called upon to repay on default of the principal debtor. But in the case of an indemnity, the promisor alone is liable to the promisee for the fulfilment of the obligation.
3. A guarantor may repay the money and can sue the principal debtor for the recovery of the money so paid by him. But an indemnifier cannot take any such step.
4. In England a guarantee must be in writing, though an indemnity may be made orally. But in India none is required to be in writing.

Advantages of Guarantees:—
(*a*) Guarantees are adaptable to different circumstances.
(*b*) They provide additional protection to a banker.
(*c*) The banker is to satisfy himself of the solvency of the guarantor by independent inquiries.

Contractual Capacity for Guarantees.—Minors and lunatics have no contractual capacity to execute any guarantee bond. A guarantee from a married woman is not safe, as she might raise the plea of her acting under undue influence, which may vitiate the contract.

Firm.—A partner of a firm has no implied powers to bind his co-partners by signing a guarantee bond in the firm's name, unless he has express authority to bind the firm by such contract.

Registered Companies.—A banker should not accept any guarantee from a registered company unless there is an express provision for the same in its Articles of Association.

Consideration.—A guarantee must be supported by consideration under section 127 of the Indian Contract Act—"anything done, or any promise made, for the benefit of the principal debtor may be a sufficient consideration to the surety for giving the guarantee".

Disclosure of Material Facts.—Though the banker is not bound to disclose all that he knows about his customer's dealings, he must not conceal from the guarantor any fact materially affecting the transaction between the banker and his customer.

Sections 142 and 143 of the Indian Contract Act are worth noting.

Section 142.—"Any guarantee which has been obtained by means of misrepresentation made by the creditor, or with his knowledge and assent concerning a material part of the transaction is invalid."

Section 143.—"Any guarantee which the creditor has obtained by means of keeping silence as to material circumstances is invalid."

In view of the above sections it is not advisable for a banker to speak anything which might be misconstrued by the would-be guarantor. When the intending guarantor asks for certain information, the banker should give a straight-forward reply.

Kinds of Guarantee. (1) *Specific Guarantee*: refers to a specified transaction only. Guarantee will lapse as soon as the specific transaction is liquidated.

(2) *Continuing Guarantee.*—A continuing guarantee extends to a series of transactions between the banker and the customer within an agreed limit. A continuing guarantee is not affected by any payments, for it is framed to secure the final debit balance.

Banker's Obligations.—

(*a*) A banker cannot vary the original terms of the contract between himself and the principal debtor without the consent of the guarantor. Alteration is permissible only when the banker obtains specific powers from a guarantor to this effect.

(*b*) A banker must not, by commission or omission, release the debtor.

(*c*) A banker should reserve a clause in the contract of guarantee giving the banker necessary authority to deal with the securities as he may think fit, so that he may not be held responsible by the surety for any depreciation in those securities due to the mishandling of the customer's securities.

(*d*) A banker must not give any indulgence to the debtor unless the same is provided for in the contract of guarantee or is assented to by the guarantor. It is some-

times held that if the period of repayment is extended by a banker without the consent of the surety, the contract of guarantee is reported to lose effect on account of the alterations of the term. As there is a conflict of legal decisions on this point, it is advisable for a banker to add such a clause whereby the banker is authorised to grant extension of time from time to time, if thought necessary.

Rights of the Banker against the Surety

Right of Lien.—

(*a*) A banker can exercise a right of lien on the balance of the guarantor notwithstanding the fact that the guarantee is time-barred. But this right will not arise until a default has been made by the principal debtor.

(*b*) A surety's liability is co-extensive with that of the principal debtor.

(*c*) In the event of the insolvency of the surety, the banker can prove his claim against the estate of the surety. As soon as a bank gets the notice of the surety's insolvency or death, he should stop operation on the account and claim the money from the principal debtor and failing repayment, the banker must lodge his claim with the official receiver of the bankrupt surety or legal representatives of the deceased.

Almost every banker includes in the contract of guarantee such a clause that notwithstanding any change in the constitution of any firm or registered company, provided it is a guarantor, the guarantee shall continue. This clause fills in a loophole through which a firm or a company may escape the liability of guarantee in the case of any change in its constitution.

Surety's Right to be Discharged

A surety gets discharged from his liability in the following cases:—

(*a*) If the creditor discharges the principal debtor.

(*b*) If the creditor, without the consent of the surety, makes

a composition with, or promises to give time, or not to sue the debtor.

(c) If the creditor does any act which is inconsistent with the right of the surety, or omits to do any act which the surety requires him to do and thereby the eventual remedy of the surety against the principal debtor is impaired.

Rights of the Surety.—A surety can ask for information from the bank as to the extent of his liability, but has no right to inspect the account of the debtor. A banker should furnish such information without any commitment as to the details of the contract.

Limitation.—If the creditor fails to sue the principal debtor for the money within the period of limitation, the surety is not discharged from his liability. This view is borne out by the decisions of the High Courts of Calcutta, Madras and Bombay, while the High Court of Allahabad has differed.

SECURITIES

Renewal of securities.—Renewal of securities means the issue of the new securities in exchange for existing securities. It is different from the issue of duplicate securities in case of loss, or destruction of the original ones.

In the case of *stock-certificates* the question of renewal does not arise.

In the case of *bearer bonds* renewal is necessary and permissible only when the coupons attached to the bond are exhausted. The application for renewal supported by the bond is to be submitted to the Public Debt Office or to the Treasury at which the bond is registered for payment of coupons.

In the case of promissory notes renewal is sometimes compulsory and sometimes optional. Renewal is necessary in the following instances:—

(a) If there is no cage for further endorsement or any two endorsements are made across each other,

(b) if the note is torn or damaged or found unfit for any other reason,

(c) if the endorsement is in form not acceptable under para-

graphs 47, 49, 52 and 59 of the Government of India Securities Manual,

(*d*) if the note, enfaced thrice for payment of interest, is presented for re-enfacement,

(*e*) if the endorsement is not distinct or clear,

(*f*) if the interest on the note remains undrawn for ten years or more and for other reasons.

Renewal by Heirs of Deceased Holders.—The heir of a deceased holder may apply for renewal of the securities in his name in the following ways:—

(*a*) If the deceased was a member of a Hindu undivided family governed by the 'Mitakshara Law' the person claiming the promissory notes should obtain a certificate in the prescribed form from the District Magistrate, properly sealed with the seal of his Court.

(*b*) If the nominal or face value of the Government securities in the form of stock-certificates and promissory notes left by the deceased persons does not exceed Rs. 5000/-, and if six months have elapsed since the death of the holder and the probate of his will or letter of administration of his estate or a succession certificate has not been obtained within this period, the heir should apply to the District Magistrate for a certificate declaring that he is the heir of the deceased.

Renewal Fees.—For each note four annas per cent is payable if the new note does not exceed Rs. 400/-, and one rupee for note if the new note exceeds that sum.

But no fee is payable in respect of the renewal of a note which bears no endorsement other than the endorsement by an officer of the Reserve Bank of India, the Imperial Bank of India and certain other Government officials.

Endorsement on Government Promissory Notes

Valid Forms of Endorsement.—An endorsement contains two parts, *viz.*, payment order and the signature of the endorser. The payment order may be of the following types:—

1. Pay to A,
2. Pay to A or order,

3. Pay to A and B jointly,
4. Pay to A and B or their joint order,
5. Pay to A or B,
6. Pay to A or B or order,
7. Pay to A and B or either of them,
8. Pay to A and B or either of them or order,
9. Pay to A, B, C, D and E or to any one (or more) of them,
10. Pay to A, B, C, D and E or to any one (or more) of them or order,
11. Pay to A or B and C jointly or order,
12. Pay to A and B jointly or C and D jointly or order.

Of the above forms, (1) and (2) are called simple endorsements, (3) and (4) are called joint endorsements, (5) and (10) alternative endorsements.

Simple Endorsement.—If A's name appears on the note in English, it is necessary ordinarily that his signature should tally with it letter for letter. If the signature be in Indian vernacular, it must be transliterated into English and must agree with the name in the previous endorsement.

Joint Endorsements.—In such cases the signatures of all the endorsers are to be taken. If one of the joint-holders dies, the right to dispose of the note passes to the survivor or survivors under section 4 of the Indian Securities Act.

Alternative Endorsements.—When a promissory note stands endorsed in any of the alternative forms, it may be validly disposed of either by A, or B, or C, etc., acting singly, unless the endorsement has made the note payable to more than one of the holders, *i.e.*, pay to A, B, C, D, or to any two of them, in which case signatures of the specified member, *i.e.*, two of the holders must appear. When the note is endorsed to two or more persons severally and either or any one of them dies, it may be validly disposed of by the survivor or survivors of those persons, or by the legal representative of the deceased, or by any of them.

If a promissory note stands endorsed as in (11), it can be negotiated by A singly or B and C jointly, but not by B or C acting singly. In case of A's death, the note will remain in joint names of B and C and may be negotiated by the survivors.

If a note stands endorsed as in (12), it can be negotiated by A and B jointly or C and D jointly, but not by any one of them singly, nor by A and C, A and D, B and C etc., as in (11) and will be dealt with in a manner pointed out in the preceding para.

Where A, B, C etc. are personal names, but with the addition of some description indicating official capacity or legal status etc.

Examples:—(*a*) Pay to A, President of the Sanatan Dharma Sabha.

(*b*) Pay to A, Secretary of the...Club, Calcutta.

(*c*) Pay to A, Managing Director......Co. Ltd.

(*d*) Pay to A, Superintendent, Central Jail, Dacca.

Instruction:—In the above cases the designation added after the name should be excluded from consideration and the note should be treated as the personal property of A.

Exceptions:—But if the designation is that of a Government officer, or an officer of an Indian State etc., the personal name should be disregarded and the note dealt with as if in an official capacity.

Examples:—(*a*) Pay to A, Accountant General, Bengal,

(*b*) Pay to A, Dewan of Mysore State.

Where A, B, C etc. are personal names, but represent the name of a mercantile firm.

Examples:—(*a*) Pay to Thomas Cook and Sons,

(*b*) Pay to M/s. Sant Ram, Anant Ram.

In such cases the usual signature of the firm should agree with the specimen registered at the office *where the note is presented*.

Where A, B, C, etc. are not Personal Names.—A person's authority to deal with Government Promissory Notes on behalf of a firm will be determined with reference to the terms of agreement, the rules of constitution etc. of the firm ; when the authority has been determined, the specimens of the signature of that person or persons should be registered at the Treasury or Public Debt Office.

Banks.—In the case of banks, the Government Promissory Notes may be negotiated by the endorsement of the manager or other duly constituted attorney. Banks usually confer powers upon their officials by virtue of powers-of-attorney, which should

preferably be registered with the Public Debt Office, supported by the relative resolution of the Board giving powers and accompanied by the specimens of signatures of those officials.

Other Bodies Corporate.—In such cases it is necessary to refer to the articles of association, or the law, governing the constitution of the body, in order to ascertain the authority of the person who should be legally qualified to negotiate the note.

Office-Holders.—An endorsement in favour of an office-holder (like Pay to the Superintendent, Central Jail, Alipore, the Income-tax officer, Patna etc.) *should not be recognised.*

Trust.—Section 3 of the Indian Companies Act lays down that no notice of any trust in respect of any Government security shall be receivable by Government. Endorsements like "Pay to A, Trustee for B", or "Pay to A, Guardian of B", "Pay to Judge of A, on account of B's security" should not be recognised, and words in such endorsements indicating the trust should be regarded by Treasury officers as so much surplusage, and whenever such a note is endorsed to or by A as trustee, or in any similar capacity, he should be trusted in all respects as the owner of the note in his personal capacity. It is desirable for A to get the note renewed in the name of the beneficiary, as a measure of self-protection against any liability which he might otherwise incur, in respect of his trusteeship, owing to his having dealt with the note in his personal capacity. A guardian should likewise be advised to get the note renewed in favour of the minor.

Endorsement of Women.—If an endorsement is made by a woman in English, there arises no difficulty. If the endorsement is in a vernacular, it should be transliterated into English ; and if the woman comes out in public, she should appear before a Magistrate or a Justice of the Peace to have her signature verified. If the woman is *Pardanashin,* her signature should be attested by two respectable witnesses, who must appear before the Accountant of the Public Debt Office, or a Treasury officer, or Justice of the Peace, or any Magistrate, to testify to the genuineness of the endorsement.

Endorsements by persons unable to write.—If a person can convince a Magistrate that he is for any reason unable to write and that he is the person whom he represents himself to be, the Magistrate may, at the request of the holder, sign the endorse-

ment on his behalf if he is satisfied that the holder understands the effect of the endorsement.

A signature made by means of a mark or a thumb impression which is valid under the General Clause Act (X of 1897) is acceptable. But the signature by the mark or thumb impression is to be attested and authenticated by the officer concerned before it can be accepted.

Loss of Government Promissory Note and Issue of a Duplicate Note

If a Government Promissory note is lost, stolen or destroyed an application for the issue of a duplicate should be submitted by the holder to the Public Debt Officer, accompanied by a statement of the following particulars:—

(*a*) Particulars of the note according to the following form:—
Promissory note for Rs. No. of the
Per cent Loan of..............................

(*b*) the last half year for which interest has been paid ;

(*c*) the person to whom such interest was paid ;

(*d*) the person in whose name the note was issued ;

(*e*) the particulars of the coupons attached (if any) ;

(*f*) the place for payment of interest at which the note was for the time being enfaced ;

(*g*) the circumstances attending the loss, theft, or obstruction and

(*h*) whether the loss or theft was reported to the police.

2. Such letter should be accompanied by

(*a*) the post office registration receipt for the letter containing the notes, if the same was lost in transmission by registered post ;

(*b*) a copy of the police report, if the loss or theft was reported to the police ;

(*c*) where the last payment of interest was not made by a warrant issued by the Public Debt Office, a letter signed by the officer of the Treasury where interest was last paid, certifying the last payment of interest on the note and stating the name of the party to whom such payment was made ;

(*d*) if the applicant is not the registered holder, an affidavit sworn before a Magistrate testifying that the applicant was the legal holder of the promissory note, and all documentary evidence necessary to trace back the title to the registered holder ;

(*e*) any portions or fragments which may remain of the lost, or stolen or destroyed note.

3. A duplicate of the letter to the Public Debt Officer should also be addressed to the Treasury where interest is payable.

Notification in the Gazette

Next the matter should have to be notified by the applicant in the successive issues of the Gazette of India and of the local official Gazette, if any, of the place where the loss, theft or destruction occurred in the following form:—

> "Lost" ("stolen" or "destroyed" as the case may be) "the Government Promissory Note No...........of the........... per cent loan of for Rs. , originally standing in the name of , last endorsed to , the proprietor, by whom it was never endorsed to any other person, having been lost/stolen/destroyed, notice is hereby given that payment of the above note and interest thereupon has been stopped at the Public Debt Office, and that application is about to be made for the issue of a duplicate in favour of the proprietor. The public are cautioned against purchasing or otherwise dealing with the above-mentioned security."
>
> Name of Person Notifying
> Residence

If no objection is raised and the authorities are satisfied, they may order issue of duplicate note on execution by the applicant of the *indemnity bond.*

Insolvency

The Indian Insolvency law comprises two Acts, *viz.*, (1) the Presidency Towns Insolvency Act, 1909 and (2) the Provincial Insolvency Act, 1907.

In England there is a distinction between a "bankrupt" and and an "insolvent". In English Law an "insolvent" is he whose debts exceed his assets, while a "bankrupt" is he who has committed an act of bankruptcy and has been adjudicated a bankrupt. But in India both the terms are used synonymously and hardly is there any distinction between the two.

A petition for bankruptcy may be submitted either by the bankrupt himself or by a creditor or creditors. As regards the creditor's or creditors' petition, the debt owed must be at least Rs. 500/- or over, and be payable immediately or at a future date and the act of insolvency must have happened three months before the presentation of the petition.

A debtor is not entitled to submit a petition for insolvency, unless under section 14 (*a*) his debts amount to five hundred rupees or (*b*) he has been arrested or imprisoned in execution of the decree of any court for non-payment of money, or (*c*) an order of attachment in the executing of such a decree has been made and is subsisting against his property.

An act of insolvency may be committed in the following cases:—

1. If, in India or elsewhere he makes a transfer of all or substantially all his property to a third person for the benefit of his creditors generally.
2. If, in India or elsewhere, he makes a transfer of his property or of any part thereof with intent to defeat or delay his creditors.
3. If, in India or elsewhere, he makes a transfer of his property or of any part thereof which would, under this or any other enactment for the time being in force, be void as a fraudulent preference if he were adjudged an insolvent.
4. If, with intent to defeat or delay
   (*i*) he departs or remains out of India,
   (*ii*) he departs from his dwelling house or usual place of business or otherwise absents himself,
   (*iii*) he secludes himself so as to deprive his creditors of the means of communicating with him.
5. If any of his property has been sold or attached for a

period of not less than twenty-one days in execution of the decree of any court for the repayment of money.

6. If he petitions to be adjudged an insolvent.
7. If he gives notice to any of his creditors that he has suspended, or that he is about to suspend payment of his debts.
8. If he is imprisoned in execution of the decree of any court for the payment of the money.

ORDER OF ADJUDICATION

When the petition is submitted, the order of adjudication may be passed by the court from the very beginning. But in Great Britain, first, a receiving order appointing an official receiver is passed and then a general meeting of the creditors is called to consider any scheme for reconstruction or composition.

As the order of adjudication is passed, the property of the insolvent vests in the *official assignee* for the benefit of the creditors of the debtor. After this the court may stay any suit or proceedings pending against the insolvent.

Protection Order.—A protection order may be passed by the court to protect an insolvent from being arrested or imprisoned.

The following transactions are protected if those have taken place before the date of the *order of adjudication*:—

(*a*) any payment by an insolvent to any of his creditors,
(*b*) any payment or delivery to the insolvent,
(*c*) any transfers by the insolvent for valuable consideration, and
(*d*) any contract or dealing by or with the insolvent for valuable consideration.

DOCTRINE OF RELATION BACK

There is a vital difference is this respect between the English Law and the Presidency Towns Insolvency Act. In English Law all transactions between the commencement of bankruptcy and the date of receiving order are protected, if the person concerned receives no notice of an act of bankruptcy and acts *bona fide*. But if he receives any such notice, his transactions will not be

protected, since if a petition is made and the debtor adjudicated a bankrupt within *three months*, the *doctrine of relation back* will nullify these transactions as against the trustee in bankruptcy. This doctrine of Relation Back stipulates that all property of the debtor vests in the Trustee in bankruptcy from the date of the commission of the act of insolvency within three months of adjudication. But in the Indian Law all transactions from the commencement of the insolvency and the passing of the order of adjudication are protected, if the person concerned receives no notice of the submission of the petition for insolvency and acts *bona fide*. In the Indian Law the notice of the act of insolvency, unlike in the English Law, does not deprive the person dealing with the insolvent of the protection.

After Petition Dealings

In the English Law protection is afforded by section 46 to certain transactions made before the date of the receiving order provided the person dealing with the insolvent is not aware of the bankruptcy petition submitted. This relates to transactions with bankers. In India as soon as a banker comes to know of the adjudication of his customer in insolvency, he will have to inform the official assignee of his balance and any other property lying in his possession.

Fraudulent Preference

Fraudulent preference is defined under section 57 as follows:—

1. Every transfer of property, every payment made, every obligation incurred, every judicial proceeding taken or suffered by any person unable to pay his debts as they become due from his own money in favour of any creditor, with a view to giving that creditor a preference over the creditors, shall, if such person is adjudged insolvent on a petition presented within three months after the date thereof, be deemed fraudulent and void as against the official assignee.
2. This section shall not affect the rights of any person making title in good faith and for valuable consideration through or under a creditor of the insolvent.

CHAPTER XV

LEGAL DECISIONS AFFECTING BANKERS

1. Malik Barkat Ali Plaintiff-appellant.

-vs.-

Imperial Bank of India and others Defendant-respondents.

(A. I. R. 1945 Lahore 213: 1945)

Facts of the Case:—

The appellant Malik Barkat Ali instructed the Imperial Bank of India, Lahore, to send a draft of Rs. 5,000/- drawn on the Imperial Bank of India, Dacca, to the Crown Brand Tea Company, Dacca, to the debit of his account. His instruction was complied with by the bank and the draft was posted to the Crown Brand Tea Company of Dacca. But subsequently the purchaser of the draft, Malik Barkat Ali, changed his mind and instructed the bank to stop payment of the draft telegraphically. The purchaser himself also wired the Imperial Bank of India, Dacca, not to make payment of the draft. In the meantime the draft was duly presented by the payee, *i.e.*, Crown Brand Tea Company, endorsed in favour of the Comilla Banking Corporation Ltd., Dacca, which guaranteed the endorsement of the payee as well. The Imperial Bank of India, Dacca, made payment of the draft, as they considered that the wire received from Barkat Ali would not justify them in stopping payment. By the time a similar telegram advising the estoppel of payment was received from the issuing bank, *i.e.*, Imperial Bank of India, Lahore, when it was too late to stop payment of the draft. The appellant sued the bank for acting contrary to his stop-payment advice, but his case was dismissed by the Trial Court on the ground that the agency of the bank was terminated as soon as it had complied with the original request made by the plaintiff and had sent off the draft to the Company. So the appeal was preferred:

Points for Decision:—

What are the conditions in which a bank can stop payment

of a draft after it has reached the hands of the person in whose favour it is drawn and whether it can do so at the instance of the purchaser.

Decision:—

(i) The bank cannot stop payment of a draft unless there is some doubt as to the identity of the person presenting it. Such doubt arises when a draft is reported to be lost. In such cases the purchaser may reasonably ask the bank to be on its guard against presentation by the wrong person.

(ii) It does not appear that the purchaser is entitled to ask the issuing bank to stop payment on other grounds, such as matters relating to the consideration in respect of which the draft has been issued at his instance, for this would put the bank in an impossible situation, whenever the purchaser of the draft is dissatisfied with some bargain, which he has made with the person in whose favour the draft has been issued.

Note for a Banker:—

From the above case it will not be in order for a purchaser to stop payment of a draft, after it has been delivered to the payee and the *banker* must not comply with such instructions countermanding payment. If there is any dispute regarding the draft-money between the purchaser and the payee, that should be settled mutually between them.

2. Sahukara Bank Ltd. Defendant-petitioners.

-vs.-

Firm Jagan Nath Diwan Chand Jaini Plaintiff-respondent.

(1944) 14 Company cases 166 (Lahore High Court).

Facts of the Case:—

The plaintiff sent a hundi for collection to the Sahukara Bank Ltd., which, in its turn, redirected it to the Civil and Military Bank for collection. The hundi was collected by the latter but subsequently it went into liquidation. The plaintiff sued the defendant bank for the recovery of the money with interest and costs. The plaintiff got a decree against which an appeal was preferred to the High Court.

Points for Decision:—

Whether the collecting banker will be held responsible for the recovery of the money collected, in case his sub-agent through whom collection was effected, fails after realisation.

Decision:—

As there was no privity of contract between the plaintiff and the defendant as to the specified agent, through whom the defendant may collect, the defendant will be held responsible for any loss that the plaintiff has suffered due to the failure of the defendant's agent.

Note for a Banker:—

The case clearly lays down that a banker who undertakes the duty of collecting a negotiable instrument and for that purpose sends it to another bank for collection on his own initiative, becomes responsible by that act for any loss sustained on account of the default of the other bank. So a banker should in such cases, get a written mandate from his customers specifying the bank through which collection is sought to be effected, at their sole risk and responsibility.

3. Bapulal Prem Chand Plaintiff

-vs.-

Nath Bank Ltd. Defendants.

(A. I. R. 1946 Bombay 482:48 Bombay Law Reporter 393)

Facts of the Case:—

M/s. Ramchandra Ramgopal, merchants at Akola, drew a crossed cheque on the Luxmi Bank Ltd., Bombay, for Rs. 4,000/- in favour of Bapulal Premchand (plaintiff) or bearer. The cheque did not reach the payee and apparently appears to have been stolen in transit. The cheque was collected by the Nath Bank Ltd., on behalf of one of their customers named N. A. Gandi, who evidently had no title to the cheque. The plaintiff sued the bank for conversion of the cheque and claimed the money.

It was contended by the plaintiff that the bank acted with negligence in collecting the cheque and had, therefore, lost protection under section 131 of the Negotiable Instruments Act.

Points for Decision:—

Whether the bank has acted without negligence in collecting the cheque and is entitled to protection under section 131 of the Negotiable Instruments Act.

Decision:

(*i*) Negligence is essentially a question of fact and it must depend on the circumstances of each case whether negligence has been proved or not. Here it appears that the account was introduced by Mr. Modi, cashier of the bank. There is nothing on the face of the cheque which should put the bank on inquiry. Therefore *prima facie* the bank was not negligent in collecting this cheque which on the face of it did not in any way arouse its suspicion.

(*ii*) If a customer opens an account with cash and there is nothing suspicious about the manner in which the account was opened, the fact that the bank made no inquiries about the customer would not disentitle the bank to the protection given to it by section 131 of the N. I. Act.

(*iii*) A bank may be negligent in not making inquiries as to a customer on opening an account. However, it is not obligatory upon a bank to make inquiries as to the respectability of a customer in order that it should avail itself of the protection under section 131 It would depend upon the facts of each case and the circumstances attendant upon the opening of the account whether an inquiry as to a customer was necessary and called for or not.

(*iv*) There is no absolute and unqualified obligation on a bank to make inquiries about a proposed customer. It will be sufficient if the customer is properly introduced, *i.e.*, the bank should act on the reference of some one whom it could trust. In this particular case, the bank was given a proper reference with regard to the customer and it was not obligatory on the bank to make any further inquiries about this customer, and in having failed to make any such inquiries they are not guilty of negligence.

(*v*) There was [illegible] ank's part in collecting the cheque and [illegible] to protection under section

131 of the N. I. Act and is not liable to the plaintiff for conversion.

The case against the bank was dismissed with cost.

4. J. G. Robinson — Plaintiff-appellant.
-*vs.*-
Central Bank of India Ltd. — Defendant-respondents.

Facts of the Case:

A cheque for Rs. 2361-12-0 was drawn on behalf of the plaintiff (J. G. Robinson) by his constituted attorney in favour of the Corporation of Rangoon. The attorney sent the cheque to his clerk, one M. S. Shah, with instruction to hand over the same to the Corporation. Mr. Shah forged the endorsement of the Corporation and tendered the cheque to the respondent bank for collection in an account opened by him in the name of minor daughter Savitabai as her natural guardian. The cheque was collected and the proceeds were drawn by Shah who later on absconded. When the Corporation of Rangoon demanded of the plaintiff payment of the taxes, the fraud was detected. The plaintiff sued the bank for conversion of the cheque and claimed money.

The Trial Court dismissed the suit and so the appeal.

Points for Decision:—

Whether the bank collected the cheque in good faith and without negligence to obtain protection under section 131 of the N.I. Act.

Decision:

The most casual perusal of the cheque ought to have aroused suspicion and put the respondent bank on inquiry as to the genuineness of the endorsement on behalf of the Corporation of Rangoon, for it was crossed cheque drawn in favour of a public body and tendered by a mere clerk for collection and payment into a small savings bank account opened by the clerk in favour of an infant of whom he was the guardian.

If banks, for fear of offending their customers, will not make inquiries into unusual circumstances, they must take, with the

benefit of not annoying their customer, the risk of liability, because they do not inquire.

For the above reasons the respondent bank was guilty of negligence in receiving payment of the cheque for Savitabai and the plaintiff's claim was decreed with costs in both the Courts.

5. Champion Automobiles Ltd. Appellants.

-*vs*.-

Travancore National Bank Ltd. Respondents.

A. I. R. 1938 Madras 77 (1937) 2 Madras Law Journal 817.

Facts of the Case:

The appellants opened an account with Travancore National Bank Ltd., Madras, and there was a rule that the bank reserves the right to close any account without reference to the depositor. The account of the appellants was not being operated satisfactorily. So the bank closed the account and returned to the account-holders their balance by a payment order. In the meantime the account-holders drew a cheque, which was returned by the bank on the ground "account since closed". In the circumstances the plaintiff sued the bank for damages for dishonouring the cheque, as the account was closed without giving them reasonable time.

Points for Decision:—

It is the practice that the bank may close an account after giving the customer a reasonable notice. But here that notice was not given. So it is to be decided whether the bank can close an account without giving prior notice.

Decision:

The rule gave the bank the right to close the account at any time, without giving the plaintiff prior notice.

The appeal was dismissed with costs.

Note:

The rule authorizing the bank to close any account without reference to the customer was in the nature of a contract between the parties and so it was binding upon the customers.

6. Rochaldas Gidoomal & Co. Plaintiffs.

-*vs*.-

The Mercantile Bank of India Ltd. Defendants.

Facts of the Case:

One Verhomal, a partner of the plaintiff requested the Mercantile Bank of India at Colombo to telegraph to their agent at Karachi a sum of Rs. 3,500/- in favour of Rochaldas Gidoomal & Co.

The plaintiffs were indebted to the bank under two dishonoured bills The defendants did not pay the plaintiffs at Karachi the telegraphic transfer, but instead set it off against the adjustment of their prior indebtedness by enforcement of "general lien". The plaintiffs sued them for the payment of the telegraphic transfer and claimed, in addition, a damage of Rs. 100/- for withholding payment.

Decision:

The Judicial Commissioner held that the sum of telegraphic transfer could not be considered to have been deposited with the defendants as bankers. The transaction was the sale of a telegraphic transfer entered into for the purpose of speedy transmission of funds to Karachi. The plaintiffs were not depositors but vendees and the defendant bank as vendors were bound to deliver what they sold. The sum of Rs. 3,500/- was paid for a specific purpose and could not be set off in exercise of the right of a banker's lien.

His Lordship admitted the plaintiffs' claim for Rs. 3,500/- with costs but negatived the claim of Rs. 100/- for damages.

Note:

This decision holds that where money is handed over to a bank for transmission to another place and the bank issues a demand draft or telegraphic transfer the money must be deemed to be held by the bank under a special contract which excludes the banker's lien.

7. L. Pirbhu Dayal — Plaintiff-applicant.

-vs.-

Jawala Bank Ltd. — Defendants-opposite party.

Facts of the Case:

The plaintiff was a customer of the defendant bank. A cheque, purporting to have been signed by the plaintiff, was presented at the bank and the cheque was honoured by the bank.

When the plaintiff found that his account was debited with the amount of the cheque, he contended that he did not draw any such cheque and claimed the money from the bank, which the bank refused. The plaintiff thereupon brought the present suit.

It was contended by the defendant that the plaintiff did not keep the cheque book in proper custody and took protection under a rule of business which ran as follows:

> "Constituents should keep all blank cheque forms under lock and key, otherwise the bank is not responsible for any loss in this connection."

Decision:

His Lordship allowed the plaintiff's claim on the ground that the loss in the present case is entirely due to the negligence of the employees of the bank in not comparing the signature on the forged cheque with the specimen signature of the plaintiff.

Note for a Banker:

A bank cannot be exonerated from the liability of loss by making payment of a forged cheque on the ground that the customer was negligent in keeping the cheque book in proper custody. But a banker may be entitled to debit his customer's account even in the case of the forgery of the customer's signature as drawer where adoption or estoppel can be pleaded against him.

8. Punjab Industrial Agency Ltd. Defendant-appellants.

-vs.-

Mercantile Bank of India Ltd. Plaintiff-respondents.

(I.L.R. 11 Lahore 667 A.I.R. 1930 Lahore)

Facts of the Case:

M/s. Sukhdeo Singh Joti Prashad had an overdraft arrangement with the Mercantile Bank of India, Delhi. They drew a cheque on the said bank for Rs. 2,000/- in favour of the defendant. The firm Sukhdeo Singh Joti Prashad countermanded payment of the cheque. But in spite of the stop-payment instruction, the cheque was paid to the defendant. The bank after discovering the mistake demanded of the defendant refund of the money, which the defendant refused. So the present suit was brought. The plaintiffs' claim was upheld in the lower court. The case was

then taken up in second appeal to the High Court and the lower court's judgment was reversed.

Decision:

There was no equity in asking a man to refund the money received by him to which he was entitled as the mistake, if any, had arisen entirely through the negligence of the bank. The holder of the cheque was entitled to know on presentation of the same whether the cheque was going to be paid or dishonoured. If he received the payment he was entitled to proceed on the assumption that the debt due to him by the drawer had been pro tanto discharged and in this particular case he did so and credited the drawer with that amount.

9. Benares Bank Ltd. Plaintiff-appellants.

-vs.-

Prem & Co. and others. Defendant-respondents.

(A I.R. '37 Allahabad 255: '37 Allahabad Law Journal, 150)

Facts of the Case:

M/s. Prem & Co. of which Premnath Bhargava and his wife Mt. Sheelwanti were represented to be the proprietors, made an overdraft arrangement for a sum of Rs. 5,000/- with the Benares Bank against securities of 50 shares of Central Bank of India Ltd., lodged with the bank supported by a transfer deed signed in blank by Mt. Sheelwanti.

The plaintiff bank instituted the suit for the recovery of its dues from M/s. Prem & Co., Premnath Bhargava and Mt. Sheelwanti. The Trial Court granted decree against Prem & Co., and Premnath Bhargava and dismissed the claim against Mt. Sheelwanti on the ground that the pledge of those shares was not valid and she was not liable for the overdraft.

The plaintiff bank proceeded against that decision to the High Court relying on sec. 237 of the Indian Contract Act which read, "when an agent has, without authority, done acts or incurred obligations on behalf of his principal, the principal is bound by such acts or obligations if he has by his words or conduct induced such third person to believe that such acts and obligations were within the scope of agent's authority". But the Hon'ble Judge dismissed the suit against Mt. Sheelwanti.

Decision:

There was no relationship of principal and agent between Premnath Bhargava and Mt. Sheelwanti ; the husband had no right whatsoever to deal with wife's shares and the bank could obtain no title to them.

Note:

A banker must ascertain to his satisfaction that the person who pledges the shares must have the right to do so. If he has no title to the shares he pledges with the bank, the latter has no recourse against the genuine owner.

10. Secretary of State — Appellant.

-vs.-

Bank of India Ltd. — Respondents.

(65 Indian Appeals 286: A.I.R. 1938 Privy Council 191)

"A lady named Gangabai was the endorsee and holder of a Government Promissory Note for Rs. 5,000/-. A broker named Acharya, having possession of the note on the lady's behalf, forged her endorsement on it in his favour and endorsed it for value to the respondents. The respondents acting in good faith applied to the Public Debt Office under the Indian Securities Act, 1920, to have a renewed promissory note payable to them issued in exchange for the note which the respondents gave up in exchange. The lady, on becoming aware of the fraud practised by Acharya and the dealing with her note on the part of the respondents and appellant, which constituted a conversion of her property by either or both as well as Acharya, sued the appellant for conversion and recovered the appropriate damages. The appellant brought the present action against respondents claiming to be indemnified against the loss thus sustained by him on the principle that Public Debt Office had issued the renewed note at the request of the respondents and was accordingly entitled to be indemnified against the damage resulting from the fact that what had been done involved an inquiry into a third party's rights. So far as the renewed note was concerned, it was rightly accepted on both sides before their Lordships that it constituted a new contract between the Government and the respondents, which was not affected by the circumstances under which it was issued."

Decision:

Their Lordships of the Privy Council observed as follows:

(*i*) Under the Indian Securities Act, 1920, the Public Debt Office could insist on an indemnity before renewing the promissory note. But it is not necessary that they should do so in every case and their omission in this respect did not deprive the Government of the indemnity *implied under the Common Law* from the person at whose request a Government promissory note was renewed.

(*ii*) The statutory provision to demand an indemnity before renewal of the promissory note did not exclude the common law right of implied indemnity.

(*iii*) From the standpoint of enquiry the respondent bank, which purchased the note bearing forged endorsement for profit, should bear the loss, and not the Public Debt Office, which performed its statutory obligation in a ministerial capacity by complying with the request for renewal made by the respondent bank.

Note:

(*a*) Forgery confers no title. A person who has got renewed in his name the promissory note, is bound to indemnify the Government against any claim made by the genuine owner of the original note.

(*b*) A renewed note constitutes a new contract between the Government and the person obtaining valid title to it. *Forgery of the original note will not affect the valid title of the latter to the renewal note.*

11. Kunhunni Elaya Nayar — Plaintiff-appellant.

-*vs*.-

Krishna Pattar and others — Defendant-respondents.

(A.I.R. 1943 Madras 74: 1942(2) Madras Law Journal, 1920)

The matter came up for decision before a Bench of the High Court, who decided as follows:

"We think that when a person delivers a share-certificate to another to be held by him as security, there is under the law of India a pledge which he can enforce and unless the

13. In the case Dulichand *vs.* Jawala Prosad & Sons it was held that the banker advancing money against railway receipt, sent to him for collection of money from the consignee, does not become a bailee of the goods thereby, having the duty to take care of the goods unless he takes possession of the goods covered by the railway receipts.

14. Mercantile Bank of India Ltd. Defendant-appellants.

-vs.-

Central Bank of India Ltd. Plaintiff-respondents.

(I.L.R. 1938 Madras 360: A.I.R. 1938 Privy Council 52)

Facts of the Case:

C. K. Narayan Iyer & Sons, dealers in groundnuts in Madras, made overdraft arrangements with the Mercantile Bank of India Ltd., and Central Bank of India Ltd., at Madras, against pledge of railway receipts. According to the practice the bank's godown-keeper used to clear the goods and store those in the bank's godown by surrender of the relative railway receipts. Sometimes the bank's godown-keeper, in order to avail himself of the merchants' services, used to hand the railway receipts back to the merchants only for the specific purpose of clearing the goods from the Port Trust and storing them in the Bank's godown. The railway receipts, which were thus handed back to those merchants by the Central Bank were misused for securing advances from the Mercantile Bank of India for the second time. Later on, the fraud was detected. There was a difference of practice between the two banks. The Mercantile Bank of India used to put the stamp of the bank on the railway receipts pledged with them, whereas the Central Bank of India did not follow such a procedure but parted with the railway receipts without any stamp whatsoever.

It was contended by the appellants that the Central Bank of India did not do anything whereby the appellant could be put on enquiry as to whether the railway receipts were pledged with the Central Bank and so they could not be held responsible for conversion of the commodities secured by railway receipts.

Decision:

It was held that the respondents having obtained a valid pledge of the goods from the merchants by the pledge of the

receipts did not lose their rights as pledges by what the merchants then did when they purported to pledge the goods with the appellants.

Further it was held that the question of estoppel could not arise, as the respondents did not owe any duty to the appellants in this connection.

The appeal was dismissed with costs and the Central Bank of India won the case.

15.	Julio Mascarenhas and others	Appellants.
	-vs.-	
	Mercantile Bank of India Ltd.	Respondents.

Facts of the Case:

In 1914 the appellants, at that time residents of Goa, entrusted one Fernandes with the collection of interest on certain securities on their behalf. Mr. Fernandes remitted the interest regularly for some time and then he defaulted. It was later on detected that the securities were transferred in Fernandes's favour by forged endorsements and Fernandes pledged those securities with the Alliance Bank of Simla. These securities were later on issued in the name of the Alliance Bank of Simla clear of all previous endorsements. Thereafter Fernandes transferred his loan account to the Mercantile Bank of India, in whose favour those securities were then endorsed by the Alliance Bank of Simla. The forgery having been detected in 1923, the appellants instituted the suit against Fernandes and the Alliance Bank of Simla. The action was defended by respondents only.

The appellants got a decree in the Trial Court, but it was reserved on appeal and they preferred the appeal to the Privy Council.

Decision:

(1) The renewals of the original securities on which the endorsements were forged constituted a new contract between the trustees of debentures and the Alliance Bank of Simla and were transferable by endorsement.

(2) There was no irregularity in the transfer of the renewed securities to the respondents which could have put them on inquiry.

(3) The respondents were holders in due course under section 9 of the N. I. Act and therefore protected.

So the appellants had no valid claim against the renewed securities in their possession and the appeal was dismissed with costs.

16. Bank of Baroda Ltd. Defendant-appellants.

-vs.-

Punjab National Bank Ltd. & others. Respondents.

Facts of the Case:

One Mr. Ghose had an account with the Bank of Baroda, Calcutta, and had an overdraft arrangement with that bank on the guarantee of one Mitter, who had an account with the Punjab National Bank Ltd., Calcutta. Mr. M. P. Amin was the Manager of the Bank of Baroda, Calcutta and Mr. Bhagwan Das of the Punjab National Bank, Calcutta. On a particular day, *i.e.*, 13th June, '39, Mr. Mitter brought to the Punjab National Bank two cheques drawn by Ghosh on the Bank of Baroda, each marked "good for payment up to 20th June, 1939" under the signature of Mr. M. P. Amin, Manager of the Bank of Baroda. One such cheque was for Rs. 1,35,000/- and another for Rs. 1,40,000/- each dated 13th June, 1939. Mr. Mitter wanted to overdraw his account with the Punjab National Bank up to Rs. 2,40,000/- against those cheques but Bhagwan Das told him that he wanted a cheque the date of which was the same as that on which payment was to be made. Mitter then took away the cheques and returned a little later on the same day with one cheque dated 20th June, 1939, drawn by Ghosh on the appellant bank in favour of Mitter or order for Rs. 2,75,000/- and marked good for payment on 20.6.39, under the signature of Mr. M. P. Amin on behalf of the Bank of Baroda. Against those cheques Bhagwan Das gave Mitter credit for Rs. 2,40,000/-.

In the meantime the management of the Bank of Baroda got scent of such irregularities and suspended Mr. Amin on the 19th June, 1939, and cancelled his Power-of-Attorney on the 20th June, 1939. The cheques in question were presented over the counters of the Bank of Baroda and were returned under the ground "not arranged for".

The Punjab National Bank sued the Bank of Baroda for the payment of the money and obtained the decree. On appeal that decision was confirmed by the Chief Justice. The appellant preferred this appeal to the Privy Council, who gave decision as follows:

Decision:

(1) Marking or certification is neither in form nor in effect an acceptance of which the holder or payee can avail himself.

(2) A custom has grown up among bankers themselves of marking cheques as good for payment for the purpose of clearance by which they become bound to each other. This practice seems to be simply that after clearing hours a cheque presented for clearing may be marked and then be paid on the next day when clearing business is resumed. The certification or marking cannot, however, be identified with an acceptance, the effect of which is to create a negotiable liability.

(3) There was no sufficient evidence in the case to justify finding of a custom to identify certification with acceptance. However, there was evidence to the effect that it was unusual to certify *Post-dated Cheques* and indeed that it was almost unknown.

(4) There was neither privity of contract nor any consideration passed between the appellant and the respondent in respect of the certification on the cheque. As the certificate was not negotiable as an acceptance in the proper sense, the respondent bank could not be considered as a holder in due course of the certified cheque.

(5) If the cheque had not been post-dated, the certification might also be held to include a representation as to the-then sufficiency of drawer's account. But as the cheque was not due for payment until seven days later, a representation as to the-then position could not go far. The promise might be revoked or disowned.

(6) The authority of the manager did not extend to certifying the post-dated cheques.

(7) A court of law has to decide a case according to law and not on grounds of banking ethics or etiquette or good banking policy as a matter of business.

Held: for the above reasons the appeal was allowed with costs.

(In the East Punjab High Court)

17. Juj Sports Limited *vs.* The New Bank of India Ltd.

Achhru Ram J.

July 2, 1948.

Facts of the Case:

The petitioners were carrying on sports-business in the city of Sialkot. While they were carrying on business at Sialkot, the petitioners used to hand over for collection to the Sialkot branch of the New Bank of India Ltd., their bills drawn on their several customers. The bank suspended payment on 26th September, '47. From 15th March, '48, a scheme for a re-constructed management of the bank was sanctioned. By Clause 4 of that scheme the amount of deposits or any other claims or dues to the credit of each customer as on 26th September, '47 or on such later date of it, the liability may have arisen in favour of such creditor, has been reduced by 20% and the balance of 80% has been made payable by instalments. The bank realised some bills on account of the petitioners whereupon the petitioners asked for refund of the bill-proceeds, as, according to them, the bank, in such a case, was holding the money as trustee for the customers.

Decision:

Where a cheque or a bill or any other document is entrusted to a banker by a customer for collection, the former receives the cheque or the bill or the other document, and collects its amount, as an agent for the latter. Where a banker has, pursuant to the instructions, express or implied, of the customer credited the proceeds of the cheque or the bill or the other document entrusted to him for collection to the account of such customer, the parties stand, as from the time of his doing so, to each other in the relation of a debtor and creditor. This rule, however, does not apply where the banker had suspended his business before the receipt by him of the amount of such cheque or bill or other document. In such a case, the banker holds the money as

trustee for the customer, irrespective altogether of the consideration whether or not the latter had an account with him on the date of the receipt of the money, and whether or not the money has been credited in that account. Unless and until the proceeds of such cheque, bill or other document have been actually credited to the customer's account under the latter's express or implied authority, the relationship of debtor and creditor does not come into existence between the banker and the customer and the former holds such proceeds as the latter's agent. The mere circumstance that the customer was the banker's constituent at the relevant time and had an account with him to which the proceeds could have been credited is not enough to create such relationship.

A sundries account and a suspense account in banking phraseology are interchangeable terms. A banker holding money of a person in suspense does not treat it like an ordinary customer's money and the general rule that a banker is entitled to use his customer's money because it is money really advanced to him cannot apply to such money.

The respondents were ordered by the Court to pay to the petitioners in full the bill-proceeds less collection charges and other incidental expenses.

CHAPTER XVI

BANK ACCOUNTS AND AUDIT

THE books of accounts of the bank are maintained in accordance with the transactions usually done by it. According to Indian Companies Act, every company shall maintain some statutory books, *viz.*, share ledger, register of members, shareholders' index book, Directors' minute-book, shareholders' minute-book, register of Directors and managers, register of mortgage and charge and annual list of members and summary. Besides these the bank generally keeps the following books:—

1. Counter receipt book.
2. Counter payment book.

2a. Subsidiary book.

3. Cash balance book.
4. Main cash book.
5. General ledger.
6. Profit and Loss analysis book.
7. Bill discounted book.
8. Cheque discounted book, both local and outside.
9. Foreign bills acceptance book.
10. Securities register.
11. Securities register in respect of valuables received from constituents for safe custody.
12. Journals.
13. Current deposit ledger, savings banks, fixed deposit ledger, etc.
14. Loan ledger.
15. Investment ledger.
16. Branch ledger.
17. Daily balance book.
18. Stock of printed matters.
19. Register for letter of credits issued etc.
20. Bills register inward and outward.

Counter Receipt Book.—This book is kept by the receiving cashier who makes entry as and when he receives money over the counter from the constituents. By initialling the counter-part of the paying-in-slip the cashier acknowledges the amount. In order to be sure that all moneys received over the counters are duly entered in counter receipt book the paying-in-slip should be passed through the hands of more than one person who will enter the amount in their respective books. After that the paying-in-slip should be countersigned by some responsible officer of the bank. One separate book is maintained for cheques received for collection on behalf of the customers.

Counter payment book is kept by the paying cashier who makes entry in this book as and when he makes payment in the counter. The details of the payment are entered in the books and particulars of notes and coins, etc. are noted on the back of the cheques or drafts against which cash payments are made. After payment of the cheques the paying cashier makes his initial on the face of the cheque. According to the volume of business the number of paying and receiving cashier is determined and in some cases when the cash transaction is small the work of the paying and receiving cashier is done by one person and in that case one counter cash book is maintained instead of separate books.

When a cheque is presented in the counter for payment, a token is given to the counter in acknowledgment of the receipt of cheque. The clerk after making entry in the token register forwards the cheque to the ledgers where specimen signature is verified and after verification it is entered in the ledger. The Passing Officer, being sure about the correctness of the entry of the ledger-keeper, sends the cheque to the manager or accountant or other authorised officer for final payment-order through some balance-book where the balance of the account and the amount drawn are mentioned. From there the cheque goes to the counter for payment and if there is any irregularity in the cheque, the cheque is returned after surrender of the token.

When the day's transaction is over, the daily receipts and payments, whether cash or transfer, are entered in two more subsidiary books. The subsidiary cash books are classified according to the ledger. Sometimes for each current ledger one subsidiary book is maintained and sometimes two or three ledgers' transac-

tions are entered in one subsidiary book. This depends upon the volume of transactions.

From the cheques received over the counters for collection it is sorted: which one is to be collected through clearing house and which one is to be collected in cash. A separate book is maintained to record cheques which are to be collected through clearing house.

Cash balance book is maintained by the cashiers in order to ascertain the day-to-day cash position.

Main cash book starts with the opening balance of cash which remains at the close of transactions of the previous day. The total of the subsidiary books, both debit and credit, whether cash or transfer is entered in the cash books. The other receipts and payments are also entered. The total of the daily Profit and Loss items is recorded in this book. After all these entries the cash book is balanced and the balance will agree with the balance of the cash balance book.

Bill Register.—Two separate Bill Registers are usually maintained, one for Inward Bills and the other for Outside Bills received from various customers. The details of the bills are recorded in this book including drawer, drawee through whom to be collected, amount, tenor, etc. When the bills are collected, they will be entered in the register and one responsible person should initial his name in the column specified for that purpose in token of its collection and due credit in the respective account. Some responsible person should scrutinise the Bill Registers occasionally in order to satisfy himself that no bills remained uncollected for a long time without any reminder from the department concerned.

If circumstances require there may be a bill payable book in which the details are recorded of all bills accepted and payable by the bank. This book is to be checked so that no double payment is made.

The bank generally issues pay-orders in respect of all expenses payable by the bank. In that case a Pay-order Issue Book is to be kept. At some intervals the list is to be made for all outstanding pay-orders and the balance should agree with general ledger-balance.

Previously remittance was facilitated by drawing hundis from one place to another, but at present, besides hundis, remittance is

made by bank by issuing draft from one branch to another at nominal charge and cash-transfer has, to a great extent, diminished in comparison with past times. As every branch of the bank issues drafts on another branch, these inter-branch transactions are made through Head Office or Central Office a/c, because for every branch, it is not possible to maintain a/c with other branches of the same bank. The reconciliation of Head Office or Central Office a/c with that of the branches is to be made at regular intervals and it should be scrutinised and enquiries should be made for any unusual debit or credit.

Journal.—It is a book through which transfer entries on rectification of errors are made. Generally all closing and adjustment entries are made through this book.

General Ledger.—The posting of the Main Cash Book and journal is made in this book and the balance of this book when entered in a sheet of paper will be the trial balance which will show the actual position of the bank.

Profit and Loss Analysis Book.—From the name it implies the book in which the details of all Profit and Loss items are mentioned, namely, interest, commission, incidental charges, establishment, rent and taxes, etc. The daily balances of the Profit and Loss a/c both debt and credit, are posted in the General Ledger and the details of these balances are posted direct from the main cash book in the Profit and Loss analysis book.

Bill Discounted Book.—It is a book in which the details of all bills discounted are entered. The bank gets a commission for discount of the bills which will mature on some fixed date. By premature discounting of the bills the banks help the businessmen with finance. Before discounting the bank should, first of all, judge the financial stability of the drawer and drawee of the bills. When a bank discounts a bill of exchange, the whole of the discount is credited to a discount a/c. At the date of financial closing some bills may not have matured and in that case the whole of the discount which was credited to discount a/c cannot be said to have been earned in that period. The unexplained portion of such discount is carried forward by transferring the amount to rebate on bills discounted a/c which will have to be shown as a liability in the Balance Sheet and in the next year it will have to be transferred to a/c

Cheque Discounted Book.—This book is maintained in which the details of all cheques discounted are recorded. The book should be scrutinised at some interval in order to see that no unusual delay is made in collection of the cheques. Before discounting a cheque the bank should judge the party. Unknown person's cheque must not be discounted at all.

Foreign Bills Acceptance Book.—This is a book where all foreign bills accepted on behalf of its customers are recorded. As the parties are unknown to each other the bank accepts the bills at the request of its customers in order to facilitate the transaction. As the bank will be liable to pay, the bank does not accept the bills unless the full security is pledged to the bank by the party for whose benefit the bank accepts the bill. In this book the details of the bills and the particulars of the security lodged are recorded. Before payment of the bills, the bank generally does not pass any entry in its book. At balancing time, the bank's liabilities in respect of all foreign bills accepted on behalf of the customers but not paid, will have to be ascertained. Against this liability the bank has full securities pledged with it. So practically the bank is fully secured of its liability in this respect. However, this liability is shown in the Balance Sheet under the heading "Liability by Acceptance or Endorsement from Customers" and the corresponding amounts are shown in the asset-side of the Balance Sheet under the heading of 'Liability of Customers on Acceptances per contra'. This will not affect the agreement of the Balance Sheet as the amounts in both sides are equal.

Securities Register.—This book records all securities against which loans are granted. The particulars of all securities are recorded in this book as and when loans are granted.

Security Register in respect of Safe Custody Deposit.—The details of each and every deposit are to be recorded in this book. When parting with the securities the initials of the depositors are to be kept in this very ledger in the column specifically meant for this purpose.

Current Account Ledger.—This is a ledger wherein the deposits and withdrawals of each customer are recorded as and when the customer deposits or withdraws money. The ledger is ruled with columns: *viz.*, date, name, deposit, withdrawal, balance, initial and product. The name, address and description

of each account are mentioned at the head of the account. In case of overdraft the limit and securities also are noted. Generally a bank of importance has to maintain several current deposit ledgers and in that case each and every ledger should be kept in a self-balancing system in order to facilitate the detection of errors. Current ledgers should be balanced at the end of every week and the total of the balance of all accounts will agree with General Ledger balance. If the ledgers are maintained in self-balancing system and the balance of all ledgers does not agree with the General Ledger balance, then at a first glance it can be ascertained in which ledger there is the discrepancy, and if that particular ledger is checked the error will be detected. But if the ledgers are not maintained in self-balancing system it cannot be ascertained in which ledger there is the discrepancy and in that case all ledgers are to be checked to find out the error.

Savings Bank Ledger and Fixed Deposit Ledger contain an account of each deposit, the rate of interest and in case of fixed deposit the date of maturity is noted in the ledger. These deposit ledgers contain an interest column in which interests are accumulated at regular intervals, say, half-yearly.

Loan Ledger.—This book contains the ledger account of all persons to whom loans are granted. The terms of loan, securities, date of repayment, etc., are noted in this book.

Investment Ledger.—It is a book where the separate account of the bank's each and every investment is recorded. The book should be columned in such a way that the face value, cost price, date of interest receivable, date of repayment of the investment, etc., can be recorded in a distinct way.

Branch Ledger.—This book is usually maintained by Head Office where separate account of each and every branch is opened: all inter-branch transactions are posted in this book.

Daily Balance Book.—In order to ascertain the daily position of the bank this book is maintained where the total of General Ledgers is recorded in a Balance Sheet Form.

Stock Register of Printed Materials.—As the bank consumes a huge quantity of printed matters and stationery the details of each account should be maintained mentioning in and out. Before placing any order, quotations should be obtained from two or three dealers and orders should be placed with the dealer

whose tender is the lowest. The control of stationery should not be vested in a single person and again the despatch of printed matters and stationery to the branches should be checked by an independent person before they are booked.

These are the books which a bank usually maintains. Besides these, the bank may keep other books according to its necessity. Some banks do foreign exchange business and in that case they maintain other sets of books.

At some intervals the pass books should be checked with ledger accounts by some responsible officer. The pass books must not be handed over to the customer with the signature of the ledger-keeper. One responsible officer should make his initial in the pass book.

If we consult the Profit and Loss account of any bank, we shall find that establishment charge is one of the big expenditures of the bank. The management should see that there is not any loophole in this department and the responsibility is not entrusted to one single officer. The allocation of duty should be entrusted to more than one officer and before any amount is debited to this account, it must be internally checked.

Another big expenditure is interest on deposits. The method of calculation and payment should be internally checked.

As the bank deals with the public money, its prosperity depends on the public faith, and public faith cannot be gained without efficient management and thorough internal checking.

Bank Audit

The functions of the bank are multifarious. The bank does many functions either for its own earnings or for the interests of its constituents. So detailed checking in all its spheres is not possible for a bank auditor. Before taking up the audit of a bank the auditor should, first of all, ascertain the system of internal check, which is usually carried on by the bank's own staff. He should be satisfied that there is some sort of checking in respect of every transaction carried on by the bank. As bank handles cash transactions, the morality of the staff should be preserved at the highest degree and that morality, to some extent, depends on the system of internal check. If each and every transaction

passes through three or four hands, the chance of the misappropriation is lessened and that also cannot be done without any collaboration and if any crime is done in collaboration that crime must be out to-day or to-morrow. If the auditor is satisfied with the system of the internal checking, he may depend to some extent on that checking. After visualising the whole system he will fix up his audit programme.

The main points in respect of bank audit are:

(*a*) To verify the cash balance on the last day of the financial closing either by actual counting or weighing or partly by one way or partly by another.

(*b*) To ascertain whether all cheques included in the cash balance are subsequently cashed and accounted for.

(*c*) Stamps in hand or stamped paper in hand also are to be checked. As it is a minor point, some auditors ignore it.

(*d*) *Bank Balance*.—To check pass books of other banks with the bank ledger is not sufficient. The auditor must obtain the certificates of the respective banks in support of the deposits held with them.

(*e*) *Security*.—Verify the Government securities and other investment in shares, etc., with investment ledger or schedule in which all details of the investments are to be recorded. If, on the date of inspection, some investments are sold or in any other way disposed of, ascertain whether all such investments are actually in the custody of the bank at the date of the financial closing. Being satisfied on this point, the auditor should enquire into the basis of the valuation. The basis of valuation should, in all cases, be cost or market price whichever is lower. If the market price goes down, please see whether proper provision is made for such depreciation. It may be that some investments are charged with some other banks against loan, etc. ; and in such a case the verification of such investment will be by obtaining a certificate from that bank specifying that such investments are held by them on behalf of the bank whose accounts are being audited.

(*f*) Re: Interest accrued but not due on Government or other securities, loans and advances etc., check the calculations at random and if it is found all right leave the matter. See that no interest is calculated on such investments whose realisations in your opinion seem to be doubtful. For interest which is not tax-free, provision for tax will have to be made.

(*g*) It is to be seen that income from all investments is duly accounted for.

(*h*) *Loans and Book Debts.*—Check the balances of the loan accounts on the schedule on balance book and see that the total of the schedule agrees with the balance of the General Ledger. Verify the securities, pronotes etc., against which loans are granted. Take note of the pronotes which are time-barred. In case of loan granted against Life Policy, surrender value of each policy is to be obtained from the Insurance Company. If the loans are against immovable properties, see that the Mortgage Deeds are duly registered and section 109 of the Indian Companies Act is complied with. In case of advance against hypothecation of stock-in-trade, see that stock-statements are regularly submitted by the constituent; go through the statement, and ascertain the basis of valuation. Compare two or three stock-statements and see whether the goods are out of market or not. From the operations of the account you will be able to form an idea of the nature of the account.

(*i*) *Bills in hand.*—Scrutinise a few days' transactions after the financial closing date and see that they are actually in hand; if not, proper provision is to be made.

(*j*) See whether proportionate commission on bills discounted but not mature within the financial closing date is duly carried forward according to the basis of the previous year. Otherwise profit will be inflated.

(*k*) *Debts due by Directors or others.*—This should be scrutinised and actual position should be shown in the Balance Sheet. In some concerns it has become a practice to make some transfer entries at the date of the closing and show the debts which are actually in the names of

some Directors or other interested persons to some other persons and thereby keep themselves within the Indian Companies Act and at the beginning of the new year they will reserve their previous transfer entries and actual position is arrived at. In order to detect such sort of transaction, a few days' transactions after the closing date, are to be checked. The maximum and minimum drawings are to be shown in Balance Sheet.

(*l*) See that cash balances are not inflated by showing the realisation of clean advances.

(*m*) Verify a portion of the securities held in safe custody with the Safe Custody Register and see the procedure of handing over the receipt to the party.

(*n*) See that the funds of the bank are not invested in some other concerns where Directors are directly or indirectly interested. If it is done, that must be disclosed in the Balance Sheet.

(*o*) See that the audited Balance Sheets and certified Returns of the branches are duly incorporated in the Central Office Books.

(*p*) *Reconciliation of Branch on other accounts.*—Usually all inter-branch transactions are either passed through Head Office account or Central Office account In some banks reconciliations are neglected or the management of the bank do not give any importance to this department. If the day to day transactions are not reconciled in due time and adjustments are kept pending, then a time will come when these adjustments cannot be made. Taking advantage of slackness on the part of the management, the dishonest employees may misappropriate the bank's money on a debit of Head or Central Office account, and when this will be detected, the real culprit may, no longer, be in the employ of the bank ; of course, it is not the duty of the auditor to catch the culprit. The duty of the auditor is finished when the reconciliation statements of the branches are shown to him.

(*q*) Check the ledger balances of the various deposits a/c, namely, Current, Fixed, Savings, etc., with the balance book and General Ledger balance. If there is any

difference, that difference must be traced. Check at random the total. The suggestion of the balance books maintaining the current ledger in self-balancing system may be given, if not maintained. This will help to detect all future errors with the least difficulty.

(*r*) All interests due on fixed or other deposits on the date of Balance Sheet are to be proved in the Balance Sheet. Test at random the calculation of the interest.

(*s*) Check some pass books with their respective interest in the ledger and enquire whether pass books are initialled by some responsible officer. Strict orders should be given by the management that no pass books are handed over to the customers with the signature of the ledger-keeper only.

(*t*) Statements of accounts which are given to the constituents or current depositors be checked by some responsible officer.

(*u*) Call loan or overdrafts received from other banks will have to be checked with the respective statement and a certificate of balance on the date of closing is to be obtained.

(*v*) Overdue interest up to the date of closing is to be provided whether charged before closing or not.

(*w*) See that all outstanding liabilities for expenses are duly provided.

(*x*) Check balances of the subsidiary ledger to agree with the General Ledger balance.

(*y*) See that book debts are written off in accordance with the resolution passed by the Board of Directors.

(*z*) In case of scheduled banks see that the statutory deposits are maintained with the Reserve Bank.

(1) Check the balances of the General Ledger into the final accounts.

(2) Take a note of all assets and securities, which are written off.

(3) Proper depreciation on furniture, motor and landed property be provided.

System of maintaining Current and Savings Bank Ledger.— The ledger-keeper who maintains a particular ledger should not be invested with the duty of writing the balance book. Again ledger-keepers are to be transferred without any previous knowledge at least once a month from this ledger to that ledger. This prevents commission of crime with the collaboration of the depositors. Again callings of ledgers are to be made by some other persons, at least by a person who does not maintain that particular ledger. Some responsible person should finally pass the cheques after checking the ledger himself.

Though the auditors are appointed on behalf of the shareholders and they are to report to the shareholders about the activities of their Directors, yet they are to look to the interests of thousands of depositors and should reveal the correct position.

NOTES ON BANK FRAUDS

As banking is becoming complicated day by day, the possibility of bank frauds is becoming greater. It will be the duty of the customers as well as of bank officials to co-operate together to prevent such frauds. It is often said that eternal vigilance is the price of liberty. Likewise vigilance over banking operations should be exercised to check the occurrence of bank frauds. To prevent such bank frauds a high standard of public morality and honesty should have to be developed on a broader base, besides the exercise of adequate caution and supervision by the bank-management, and improvement of internal organisation and removal of defective procedure. For the fulfilment of the latter objective, expert knowledge on banking matters is required of the bank-officials. But knowledge, like a double-edged weapon, may be used as well as misused. When this knowledge is abused by a bank-official, it is equivalent to a breach of trust and duty of supervision. Shortcomings of such a nature may be overcome by the inculcation of the principles of good conduct and ethical standard.

Banking frauds take various forms. It is not possible to exhaustively deal with the devilish devices, adopted by unscrupulous persons to defraud the banks. Some indications as to their nature may provide us with certain clues for checking them as

far as practicable. Sometimes banks are defrauded by the forging of the signatures of the customers in collusion with bank-employees. The dealing clerks may remove the genuine specimen signature card of a customer from the specimen signature box and replace it by an unauthorised one, which may be shown to the supervising officer for the passing of a forged cheque. The supervising officer may, in such a case, be duped by the dealing clerk, in case he has access to the specimen signature card box. It is, therefore, essential that the bank-official takes proper custody of the signature card box and properly attests each under his own signature before he files it carefully in the box.

Sometimes an attempt of cheating may be made by writing a faked deposit-pay-in-slip, which might increase the balance of a customer and be drawn upon. Besides the counter cash-book, in which all cash deposits and cash payments are entered, there should be a separate scroll, wherein such deposits should be carefully entered, so that any such discrepancy may be rightly detected.

Another novel way of fraud is attempted through clearing. Suppose 'A' opens an account with two banks, namely, 'B' and 'C'. He draws a cheque for Rs. 25,000/- on B, although he has no such balance in his account and deposits it with C. C presents that cheque for Rs. 25,000/- through clearing and as it did not receive back the said cheque within the scheduled time of returning unpaid cheques, C thought the cheque to be paid and accordingly permitted A to withdraw the same amount. A absconded with the money. As the cash book did not agree owing to the difference of Rs. 25,000/- in the clearing column, the bank was put on enquiry. On reference to the drawee B, it was ascertained that no such cheque was presented. On investigation it appears that the cheque was destroyed as soon as the lot came out of the clearing house.

It is dangerous to allow any single individual employee to prepare a voucher, pass it and even to reverse it. If such a practice grows up, the bank might have to incur loss owing to the dishonesty of the particular employee in such a case. It is, therefore, always advisable that the voucher should be prepared by one and passed by another officer. Any entry that is to be reversed, should have the prior approval of the manager himself.

Sometimes fraud is committed by the changing of vouchers by a bank-employee in the following manner: A bank-employee, who used to receive cheques for deposit on account of customers asked the depositors to endorse the cheques in bank. He would then put another endorsement on the back in the name of a person, on whose account he used to operate. He would make entries of those cheques in the relative pass books and get those signed by the officer. He then would replace the depositor's pay-in-slip by another credit slip, made out in the name of that person, on whose account he operated. Thus he himself withdrew the money from that bogus account. Such an incident will reinforce the desirability of not allowing the ledger-keeper to receive cheques for deposits directly from the customers. Rather cheques should be received by another employee who has no connection with the ledger-keeper. Occasionally bogus cheques are manipulated to be passed for payment by the forgery of the initials of the ledger-keeper and supervising staff. It is necessary, for the sake of safety, that the cheques should bear the full signatures of the ledger-keepers and supervisors and be duly entered in a separate cheque-passing register showing the details of the cheques and bearing the signatures of the ledger-keepers and supervisors as well, before those are passed for final payment.

Sometimes the body of a cheque including the name of the payee and the amount is erased by chemicals, and new name and amount are substituted therein, while the signature of the drawer remains in tact. In such a manner attempt is made to cheat the bank. During the war such incidents of forgery by chemicals took place in quick succession. Sometimes the signature of a drawer is forged and if there appears to be a slight alteration, it is represented that the drawer is in sick-bed and so needs the money. The slight variation of his signature may, therefore, be overlooked. In such a manner some withdrawals are made, when the bank-official may ask the recipient to furnish a fresh signature of the depositor. The bank may, in good faith, supply to him a blank specimen card, which he himself completes in the same signature whereby he so long withdrew money, and returns the same to the bank, which accepts it without demur. Later on, it transpires that the new specimen signature is not the genuine signature of the depositor himself. The bank-official forgets that

the specimen card should have been completed in his presence. Sometimes an attempt to obtain a double payment of a cheque may be made, by presenting once again a cheque, which was already paid but due to the carelessness of the cashier did not bear the stamp "Paid".

Utmost stress should be laid on the careful checking of books. The checking officer must not do anything without getting himself satisfied about the matter presented to him for disposal. The bank may have to lose much due to any lack of vigilance on the part of the checking officer. The ledger-keeper may, under certain provocation, take advantage of the carelessness of a checking officer. The checking officer must see to the summation balancing regularly, carefully check every item posted in the ledger, must leave no space in the column, which may permit of any interpolation after his checking, write in words the closing balance of an account after the checking is over, total the balance books and write always in ink balances of individual ledgers. In one instance, a ledger-keeper, in collusion with his co-workers, added a digit to the previous day's closing balance after the checking was over, and got cheques passed on the basis by the checking officer, who assuming the balance to be correct, deducted the balance of such cheques from the previous balance and initialled the balance. The same ledger-keeper used to ink the balance and managed to alter the figure to cover the amount so secretly passed, on the balancing day. A ledger-keeper, handling his own ledger, should not be allowed to write the balances of his particular ledger in the balance-book but that should be done by another man, who is not directly concerned with the balances of the particular ledger. Such a practice may act as a check upon any fraudulent tampering with the balances of accounts. The checking officers must not part with the balance-books until they have completed their checking and compared their figures with the General Ledger balance-book. It is further desirable that ledgers should be checked on the following day, along with the vouchers passed on the preceding day, to verify the correctness of the balances and to prevent any unauthorised tampering.

While unremitting attention should be devoted for stopping any possibility of wrong payment of cheques, it is no less necessary to apply the same amount of caution while collecting

cheques on behalf of the customers. The cheques should be carefully examined, specially whether the cheques are crossed or uncrossed, 'order or bearer' or marked "A/c payee" and whether they are properly endorsed. If the cheques are not crossed, the bank cannot claim protection under Section 131 of the Negotiable Instrument Act, in case of any forged endorsement. So if any uncrossed order cheque is lodged for collection, the dealing officer must satisfy himself personally after proper inquiry, before such a cheque is collected at all. A banker is often required to guarantee the endorsements of the customers on their cheques. It is desirable that before such guarantee is given, the relative vouchers should be examined. Without reference to the vouchers, such a guarantee, when misplaced, may land the bank in difficulties.

While issuing any letter of credit or draft, the bank officer must examine that those documents are properly perforated and relative advices duly despatched. In the absence of perforation, a crook may, with the use of chemicals, change the amount and raise it to a higher figure and cheat the drawee office. The drawee office should compare such draft with the relative advice before making payment. Sometimes banks are victimised by certain crooks for the double payment of drafts in the following manner. A crook, who purchases a draft in favour of the third party, may represent to the bank that the draft is lost and approach the bank for refund of the purchase money. If the bank, without reference to the payee and without obtaining his consent, refunds the amount to the purchaser and in the meantime the payee presents the said draft, the bank is bound once again to make payment of the draft for the second time and thus incurs loss.

The practice of transferring funds from a customer's account at one branch to his account at another branch merely by letters (popularly called mail-transfer) signed by one officer was in vogue. But such a practice is fraught with risks if a sum larger than what was intended, is transferred by changing the body of the letter without disturbing the officer's signature. So it is advisable to introduce *pro forma* drafts in printed forms, in place of mail-transfer by letters, and those drafts and advices should be signed by two officers.

The bank may have to suffer loss due to faulty advances and defects in the securities offered. Advances against shares may be taken as examples. Cases may happen when the bank may be approached for advances against large blocks of shares. The number of shares may be altered and raised to a higher figure by crooks with the use of chemicals, while the other portion of the scrip appears as it was. Bank fraud by alteration of the number of scrips is not infrequent. So it is always advisable not to make advances without first getting the scrips registered in the bank's name. When the scrips are sent for registration, any defect in the scrips must be revealed. Similar attempt to cheat the bank may be made by forged endorsement on Government securities as well. The bank should, for safety's sake, refrain from making advances against Government papers unless those are renewed at Public Debt Office in bank's name. The bank is often to make advances on securities supported by transfer deed signed in blank. If any one, misappropriating such shares, may succeed in persuading the bank to make advances thereagainst, the bank will have no recourse against the genuine owner of those shares, if he makes any such claim. The bank sometimes may have to incur loss, in case it does not sell off the securities of the customers, who do not maintain the required margin, within a reasonable time from the sale-notice served upon such borrowers. In case the margin falls due to the failure of the bank in selling the securities in time, the bank can have no recourse against the customer and may have to compensate him for the loss. As regards the renewal of Government papers, prompt steps should be taken to forward the papers to Public Debt Office. In one instance, a public company endorsed a paper in bank's name through its properly constituted attorney. But the power-of-attorney of the company was not registered with the Public Debt Office. And sometimes after the company went into liquidation, the bank could not arrange to produce the power-of-attorney nor the minutes of the meeting of the Board granting the power-of-attorney and so lost the money.

Sometimes banks have been found suffering heavy losses on account of advances being made against goods, sent on a consignment basis. Due to carelessness on the part of the bank to scrutinise properly the manufacturer's invoices, which show that

the goods are on a consignment basis, and for their lack of care in ascertaining whether the goods have been paid for, some banks had to part with the goods they accepted as securities to the unpaid vendors and had to incur losses. Often the banks are duped by advancing against delivery orders on firms, of which the borrowers themselves are the proprietors or partners. A banker should examine whether the invoice is in order or genuine. A hides merchant cheated a bank by tendering false invoices. While the bales of hides contained kid skins, the said merchant prepared and handed over to the bank invoices which showed the contents as goat skins. The skins were of inferior quality but the invoices were made out at high prices. Whenever the bank put pressure upon the merchant to clear the old stocks, he arranged to take delivery of the bales at the port towns and managed to send back the same through one of his representatives, making the bank believe that the old stocks have been taken delivery of. The bank, relying too much on the borrower's own statement, had at last to pay a heavy penalty for its mistakes.

A banker's path is virtually a path of thorns. There is every possibility of his being waylaid if vigilance on his part is, in the slightest degree, relaxed. But even the best of judgment will be of little avail if the circumstances so adversely develop as to outwit him. A banker is often called upon to help business which cannot continue without the basis of trust and how often trust is misplaced. Still a banker is to make headway in the face of so many difficulties and odds.

APPENDIX A

Form of Balance-Sheet as prescribed by the Banking Companies Act, 1949.

CAPITAL & LIABILITIES	Rs. nP.	Rs. nP.
CAPITAL		
AUTHORISED CAPITAL—		
Shares of Rs. ... . each ..	...	...
ISSUED CAPITAL—		
Shares of Rs. .... each ...	...	...
SUBSCRIBED CAPITAL—		
Shares of Rs .... each ...	...	...
Amount called up at Rs. ...... per share	...	...
Less calls unpaid	...	...
Add forfeited shares ..	...	...
RESERVE FUND AND OTHER RESERVES		
DEPOSITS AND OTHER ACCOUNTS—		
Fixed Deposits	..	...
Savings Bank Deposits, Current Accounts, Contingency Accounts, etc.	...	...
Borrowings from other banking companies, Agents etc.:		
(i) in India	.	...
(ii) outside India	...	...
Particulars:		
(i) Secured (stating the nature of security) ..	...	...
(ii) Unsecured	...	...
Bills payable		
Bills for collection being bills receivable as per contra		
(i) Payable in India		
(ii) Payable outside India ...	..	...
Other liabilities		
Acceptances, endorsements and other obligations per contra	..	..
PROFIT AND LOSS		
Balance as per last Balance Sheet		
Less appropriations .	...	..
Add profit for the year brought from the P. & L. A/c. ...	...	...
CONTINGENT LIABILITIES ...	..	...
Total		Total

PROPERTY & ASSETS	Rs. nP.	Rs. nP.
CASH		
In hand and with Reserve Bank and State Bank (including foreign currency notes) ...	...	...
Balances with other banks (showing whether on deposit or current account):		
(i) in India	...	...
(ii) outside India	...	...
MONEY AT CALL AND SHORT NOTICE		
INVESTMENTS (stating mode of valuation, i.e., cost or market value).		
(i) Securities of the Central and other State Governments & Trustee Securities including Treasury Bills of the Central and State Governments.	...	...
(ii) Shares (classifying into preference, ordinary, deferred and other classes of shares and showing separately shares fully paid-up and partly paid-up) ...	...	...
(iii) Debentures or Bonds ...	..	...
(iv) Other investments (to be classified under proper heads)	...	...
(v) Gold	...	...
ADVANCES		
(other than bad and doubtful debts for which provision has been made to the satisfaction of the auditors)	...	...
LOANS, CASH CREDITS, OVERDRAFTS ETC.		
(i) in India	...	...
(ii) outside India	...	...
BILLS DISCOUNTED AND PURCHASED (excluding *Treasury Bills of the* Central & State Governments):		
(i) Payable in India ...	...	...
(ii) Payable outside India ...	...	...

PROPERTY & ASSETS	Rs. nP.	Rs. nP.
PARTICULARS OF ADVANCES		
(i) Debts considered good in respect of which the banking company is fully secured	...	...
(ii) Debts considered good for which the banking company holds no other security than the debtors' personal security	...	...
(iii) Debts considered good, secured by the personal liabilities of one or more parties in addition to the personal security of the debtors	...	...
(iv) Debts considered doubtful or bad not provided for ...	...	...
(v) Debts due by Directors or Officers of the banking company or any of them either severally or jointly with any other person ...	...	...
(vi) Debts due by companies or firms in which the Directors of the banking company are interested as Directors, partners or managing agents or, in the case of private companies, as members	...	...
(vii) Maximum total amount of advances, including temporary advances made at any time during the year to Directors or managers or officers of the banking company or any of them either severally or jointly with any other person ...	...	...
(viii) Maximum total amount of advances including temporary advances granted during the year to the companies or firms in which the Directors of the banking company are interested as Directors, partners or managing agents or, in the case of private companies, as members ...	...	...
(ix) Due from banking companies	...	...

PROPERTY & ASSETS	Rs. nP.	Rs. nP.
Bills receivable being bills for collection as *per contra*: ...		...
(i) Payable in India ...	...	...
(ii) Payable outside India ...	...	
Constituents' liabilities for acceptances, endorsements and other obligations *per contra*.		
Premises *less* depreciation.		
Furniture and fixtures *less* depreciation.		
Other assets, including silver (to be specified).		
Non-banking assets acquired in satisfaction of claims (stating mode of valuation).		...
PROFIT AND LOSS	...	
Total		Total

FORM OF PROFIT AND LOSS ACCOUNT

Profit and Loss account for the year ended *December*

EXPENDITURE	Rs. nP.	Rs. nP.
Interest paid on deposits, borrowings etc.	.	...
Salaries and allowances and Provident Fund (showing separately salaries and allowances to managing director or manager or chief executive officer)	...	...
Director's and Local Committee member's fees and allowances ...	...	...
Rent, taxes, insurance, lighting etc.	...	...
Law charges		
Postage, telegrams and stamps, Auditors' fees	. .	...
Depreciation on and repairs to the banking company's property ...	...	...
Stationery, Printing, Advertisement, etc	...	...
Loss from sale of or dealing with non-banking assets	...	...
Other Expenditure	...	...
Balance of profit	...	...
Total ...		Total

INCOME*	Rs. nP.		Rs. nP.
(Less provisions made during the year for bad and doubtful debts and other usual and necessary provisions)			
Interest & Discount	...		...
Commission, Exchange and Brokerage			
Rents	...		...
Net profit on sale of investments, gold and silver, land, premises and other assets (not credited to Reserves or any particular Fund or Account).			
Net profit on re-valuation of investments, gold and silver, land, premises and other assets (not credited to Reserves or any particular Fund or Account)	...		...
Income from non-banking assets, and profit from sale of or dealing with such assets	...		...
Other receipts	...		...
Loss (if any)	...		...
Total		Total	

* 'Net loss on sale or revaluation of investments, gold and silver, land, premises and other assets, if any, may be deducted from income.'

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24. B. C. GHOSH — A Study of the Indian Money-market.
25. S. N. SEN — Central Banking in Undeveloped Money-markets.
26. L. R. SUNEJA — Bankers' Securities against Advances.
27. LONDON INSTITUTE OF BANKERS — Questions on Banking Practice.

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4. Reports and Proceedings of the Shareholders' Meeting, Reserve Bank of India.
5. Reserve Bank of India Bulletin.
6. Central Banking Enquiry Committee Report.
7. Various Provincial Banking Enquiry Committees' Reports.
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10. National Planning Committee's Report, India.
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12. All-India Rural Credit Survey Report.
13. Shroff's Committee Report.

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